PUBLIC PENSION OVERSIGHT BOARD

Kentucky Retirement Systems Administrative Subcommittee

Minutes of the 2nd Meeting
of the 2019 Interim

October 28, 2019

Call to Order and Roll Call

The 2nd meeting of the Kentucky Retirement Systems Administrative Subcommittee of the Public Pension Oversight Board was held on Monday, October 28, 2019, at 10:00 AM, in Room 171 of the Capitol Annex. Representative Russell Webber, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Wil Schroder, Co-Chair; Representative Russell Webber, Co-Chair; Senators Jimmy Higdon and Dennis Parrett; Representative Phillip Pratt; John Chilton, and James M. "Mac" Jefferson.

Guests: Jean-Pierre Aubry, Director of State and Local Research, Center for Retirement Research at Boston College.

LRC Staff: Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

Approval of Minutes

Senator Parrett moved that the minutes of the December 17, 2018 and March 25, 2019 meetings be approved. Representative Pratt seconded the motion, and the minutes were approved without objection.

Representative Webber welcomed Representative Pratt and Representative DuPlessis as new members to the committee.

Study of Composition of Public Pension Boards and Impact on Returns

Jean-Pierre Aubry, Director of State and Local Research, Center for Retirement Research at Boston College (CRR) opened his discussion by providing background on CRR, which is a nonprofit academic center founded in 1995. Initially funded through a Social Security Administration grant, the research center primarily focuses on private sector retirement issues. In 2007, the CRR began researching state and local pension plans through a grant from the Center for State and Local Government Excellence, which is a nonprofit research arm of ICMA-RC, which administers supplemental DC plans for state and local governments.

Mr. Aubry moved into his presentation, which was the result of research conducted on the relationship between board structure and composition relative to plan investment returns. Mr. Aubry pointed out that a board is tasked with oversight of administrative and investment activities of a plan, which includes certifying contribution rates, determining actuarial assumptions, setting asset allocations, hiring and firing key employees, and setting the administrative budget. However, boards can often be constrained in fulfilling its duty, such as the practice of investment "legal lists," limited governmental salaries, and an inability to change plan benefits or contribution rates paid by employees or employers. Despite those constraints, Mr. Aubry stated prior research had shown that a board's characteristics do relate to plan outcomes, and he referenced prior research that studied performance relative to the size of a board, boards with members who have financial expertise, and boards that included retired members.

With regards to the study conducted by the CRR, Mr. Aubry stated a more holistic approach was taken, rather than analyzing a single topic, such as size or member expertise. Instead, the CRR identified four key features that they believed played a role in board effectiveness, which included the structure, composition, size, and turnover of boards. Using these key features, the CRR analyzed each of these factors across the CRR's Public Plans Database (PPD), which includes roughly 200 state and local defined benefit plans, including the Kentucky Retirement Systems (KRS). Mr. Aubry noted the database covers 95 percent of public pension members and assets in the U.S., was updated quarterly with data from recently released Comprehensive Annual Financial Report or actuarial valuations, and included data from 2001 to 2018.

As to board structure, Mr. Aubry stated the vast majority, or 74 percent, of PPD plans utilized a single fiduciary board, including KRS. The remaining quarter of plans generally utilized a separate fiduciary board for investment purposes, while just under 10 percent of plans operated under an individual, sole fiduciary.

Next, Mr. Aubry reviewed the average board composition of plans in the PPD. On average just over half of a board's members were plan participants, while the other half were a mix of ex-officio and general public members. The KRS board had slightly fewer plan participants and a greater number of general public members as compared to the average large plans. Secondly, on average just under half of a board's members were appointed to those positions, while approximately a third were elected. He compared the general results to the KRS board, which had a very similar breakdown of elected trustees, but noted that Kentucky stood out in terms of appointed members with just over 60 percent.

Lastly, Mr. Aubry discussed the average board size and tenure of a board member as aggregated in the PPD. The average size board in 2017 was 10 members, but ranged from five to 19 members. The KRS board, with 19 members, ranked as one of the larger boards. The average tenure of a board member equaled six years, while the KRS board's average tenure was three years. It takes time for board members to gain knowledge and understanding of a plan, so high turnover could lead to disruption or lack of credibility with plan members and/or the legislature.

Mr. Aubry outlined the board effectiveness scoring utilized in the study. Each plan received one point for being within the suggested range of five board features, including structure, size, stakeholder representation, financial expertise, and tenure, for a highest point total available of five. The most common total score across the sample was three, with 75 plans including Kentucky earning that score. Next, the analysis compared each plan's total board effectiveness score to its 10-year trailing investment return in 2017. He pointed out that returns ranged from 3.9 percent to 6.1 percent, with all plans performing below their assumed rates of return. Kentucky's 10-year return fell into the second to last quartile at 4.9 percent, which also was below their assumed return of 5.75 percent. When the two factors were compared, Mr. Aubry stated the analysis found that plans with higher board effectiveness scores correlated with better 10-year investment performance, suggesting that an effective board can positively impact long term investment performance.

In conclusion, Mr. Aubry noted that boards are responsible for oversight of both the administrative and investment activities of plans and exhibit significant diversity across key features related to their effectiveness, which include structure, size, composition, and turnover. Research conducted by the CRR found a positive relationship between best practices in these areas and a plan's 10-year investment return, with results supporting the belief that best practices recommended by governance experts across the industry do relate to tangible plan outcomes.

In response to a question from Representative Webber regarding legal lists, Mr. Aubry stated that legal lists were very common in the 1970s and legally limited a plan to certain investment options, for example limiting or restricting plans from investing in equities. They are not as common today, but were extremely prohibitive up through the 1980s.

In response to questions from Mr. Chilton, Mr. Aubry stated that the scoring presented for Kentucky in his presentation was based on the KRS board only. In response to a follow up question, Mr. Aubry stated that the CRR does have information related to the Teachers' Retirement System (TRS) in their PPD, but it was not included in this report. In response to another follow up question, Mr. Aubry stated that the CRR was not attempting to set best practices, but rather study current board structures from a holistic standpoint and analyze if certain features tended to lead to better performance.

In response to questions from Mr. Jefferson regarding if there was any correlation between investment returns and plans with separate investment and fiduciary boards, Mr. Aubry stated that is a topic the CRR is still investigating. He noted that research conducted before the financial crisis showed some outperformance by plans that had separate investment councils, but since the crisis the data is a bit less clear. In response to a follow up question regarding why CRR assigned a point of board effectiveness to plans with a single fiduciary board, Mr. Aubry responded the decision was largely based off of best practices and research work conducted by the International Center for Pension Management and Keith Ambachtsheer, which points to a single fiduciary board having greater effectiveness.

In response to questions from Senator Schroder regarding board member financial expertise, Mr. Aubry stated that the CRR does track and maintain a breakdown for plans, including Kentucky, however, he noted this variable was very subjective and based largely on internal reviews of bios and resumes of individual board members. Given this subjectivity, CRR is very cautious of how the data is used and does not include it in the PPD available online. In response to a follow up question regarding average tenure and board size of KRS compared to the CRR research, Mr. Aubry stated that he looks at the potential upside that can be gained by being outside the norm or average. As in the case of board size, the research conducted by CRR would suggest that not much is gained by having more members.

In response to an additional follow up question regarding if complexity of a plan was considered when looking at board size, Mr. Aubry stated their specific research focused mostly on board and investment performance. However, he noted boards also have to manage other administrative and benefit-related tasks that could require expertise outside of investments. Senator Schroder commented that he believes that research on stakeholders other than financial experts would be an asset.

In response to a question from Representative Webber regarding other technical expertise, outside of investments, that a plan could benefit from, Mr. Aubry suggested having members with actuarial experience and individuals who have worked in benefit administration as best practices.

Mr. Chilton stated that he would like to see information that relates to TRS.

With no further business, the meeting was adjourned.