PUBLIC PENSION OVERSIGHT BOARD

Minutes

January 22, 2018

Call to Order and Roll Call

The 1st meeting of the Public Pension Oversight Board was held on Monday, January 22, 2018, at 1:00 PM, in Room 154 of the Capitol Annex. Senator Joe Bowen, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Joe Bowen, Co-Chair; Representative Jerry T. Miller, Co-Chair; Senators Jimmy Higdon and Wil Schroder; Representatives James Kay and Arnold Simpson; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Donna Early, Executive Director, Judicial Form Retirement System, Justice VanMeter, Kentucky Supreme Court; Beau Barnes, Deputy Executive Director, Teachers' Retirement System; David Eager, Interim Executive Director, and Rich Robben, CFA, Interim Executive Director, Office of Investments, Kentucky Retirement Systems.

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

Approval of Minutes

Auditor Mike Harmon moved that the minutes of the December 18, 2017, meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

Investment, Cash Flow, and Budget Update

Donna Early, Executive Director, Judicial Form Retirement System (JFRS) and Justice VanMeter, Kentucky Supreme Court represented JFRS. Mr. VanMeter opened with a review of investment performance for the judicial retirement plan (JRP) as of December 2017, highlighting the defined benefit plans 10- and 20-year returns of 8.74 percent and 7.40 percent respectively. The total market value of the JRP defined benefit plan was $403 million, which compared to an actuarial liability $414 million as of July 1, 2017. Mr. VanMeter also reviewed performance for the JRP hybrid cash balance plan, which has similar results to the defined benefit plans since its inception about 2.5 years ago. While the plans are managed and allocated similarly, Mr. VanMeter noted the defined benefits were actively managed, while the hybrid cash balance plans were invested in passive, index funds. Mr. VanMeter referenced performance for the legislative defined benefit and hybrid cash balance retirement plans, which had produced virtually identical results. Lastly, Mr.

VanMeter highlighted the low investment fees of JFRS, which utilizes Hilliard Lyons Trust Company as their sole investment advisor.

Mr. VanMeter pointed out that JFRS has approximately 29 judges who are in the hybrid cash plan under Kentucky Retirement System (KRS) and for the upcoming biennium KRS is going to charge 84 percent of payroll for those 29 judges, which is over $3.6 million. JFRS has 26 judges in the hybrid cash plan with a cost in the upcoming biennium of $200,000, which is a difference of almost $3 million. He believes the difference is because JFRS has kept the hybrid cash money separate as opposed to combined funds. Mr. VanMeter also stated JFRS had reduced their ARC by almost $13 million over the past four years.

Ms. Early provided a review of cash flow for the first half of the 2017 fiscal year. With regards to JRP, the plan had 350 benefit recipients, totaling approximately $2.1 million monthly for retirement and insurance benefits. Ms. Early also highlighted the funds year to date investment gains of $27 million, noting it included a realized gain of almost $20 million that was the result of the plan rebalancing their equity portfolio from 77 percent to it target of 70 percent. Ms. Early provided a similar review of cash flows for LRP, which had outgoing monthly benefit payments of $447,000 across 221 recipients. Much like JRP, $5.3 million of the $7.8 million investment gain during the fiscal year was due to rebalancing the equity portfolio.

Ms. Early reviewed the 2019-2020 budget amounts for JFRS. As noted by Justice VanMeter, the annual required contribution (ARC) for both plans has declined from the prior biennium.

In response to questions from Senator Higdon regarding the hybrid cash balance plans, Mr. VanMeter and Ms. Early stated actuarial valuation of the plans resulted in a required contribution that is less than 4 percent for the coming biennium.

Investment, Cash Flow, and Budget Update

Beau Barnes, Deputy Executive Director, Teachers' Retirement System (TRS) discussed preliminary pension investment returns as of December 2017, highlighting the plans net returns over the trailing 1-, 3-, 5-, 10-, and 20-years. Over the trailing 30-year period, the pension plan has provided a compounded gross return of 8.5 percent. Mr. Barnes also provided preliminary net of fee results for the medical trust fund over a trailing 1-, 3-, and 5-year period. Mr. Barnes noted the medical fund was a relatively new fund, largely driven by the shared solution of 2010, when retiree health care transitioned from pay-as-you-go to a prefunded plan.

Mr. Barnes provided a cash flow update and compared the first half of FY2018 with the prior year, highlighting total cash inflows, outflows, and net cash flow before asset gains or losses. Mr. Barnes noted the fund did experience some slight negative cash flow if asset gains were not considered, but indicated it was very manageable compared to what TRS was dealing with before the additional $973 million in the current budget. Mr. Barnes noted the positive investment gains for the fund and reported the pension funds total market value as of December 31 was approximately $19.8 billion.

Mr. Barnes provided a review of TRS budget request and the Governor's recommended budget. He pointed out a request of $69 million for FY 2019 and $76.5 million for FY 2020 for retiree medical contributions for post July 1, 2010 non-Medicare eligible retirees was not included in the Governor's budget. Mr. Barnes noted the additional funding requested by TRS to meet the actuarial determined employer contribution (ADEC) was included in the executive budget. In total, including statutory contributions funded through the Department of Education, the executive budget provided a total over $1.086 billion and $1.073 billion in FY 2019 and 2020, respectively.

In response to a question from Senator Bowen regarding opposition expressed by many within the teaching profession to the executive budget, Mr. Barnes indicated that much of the concern he had heard from people in the education community centered on the uncertainty or lack of funding for medical insurance needs. Senator Bowen noted that retiree medical insurance is outside the scope of the inviolable contract and in years past the state's cost has been a special appropriation by the General Assembly.

In response to a follow up question from Senator Bowen, Mr. Barnes stated that under KRS 161.675, TRS is required only to provide access to group coverage, but the statute does provide the board shall provide coverage to the extent funding is available. The board is responsible for determining how much and what plan is provided and how much members are charged for coverage. If the final budget did not provide any additional funding for insurance, the board would likely have the actuary look at the impact, provide options, and ultimately decide what they felt was most diligent.

In response to a question from Representative Miller, Mr. Barnes indicated it is common for TRS to have discussions on what is and what is not covered by the inviolable contract. Staff have traveled throughout the state to speak with both active and retired teachers and Mr. Barnes himself has given presentations that included a summary of what is and is not covered. With regards to retiree insurance, staff clearly communicates the benefit is not a guarantee and members may be required to cover the full cost.

In response to a follow up question from Representative Miller, Mr. Barnes stated that the non-single subsidy is a subsidy provided by the Commonwealth through the Kentucky Employees Health Plan (KEHP) that helps pay a portion of the cost for active teachers, active state employees, and retired teachers who have couple, parent plus, or family health insurance coverage. In the proposed executive budget it states that the non-single subsidy shall no longer be provided. Mr. Barnes indicated that about 3,500 retired members of TRS would be affected. Lastly, Mr. Barnes stated that retired teachers under the age of 65 participate in the same plan as active teachers, but retired teachers are required to contribute a portion of the KEHP premium cost that is equivalent to the Medicare Part B premium cost, which is $134 per month that the active teachers do not pay. This was part of the 2010 shared solution.

In response to a question from Senator Bowen, Mr. Barnes stated that he believes most teachers understand that health insurance is not guaranteed once retired, but believes there are likely some, regardless of the message and education provided by TRS, that believe it is part of the inviolable contract.

Representative Kay asked the State Budget Director, John Chilton, if any insight could be shared as to why the Governor's recommended budget had no appropriation for the state's portion of the shared responsibility for retiree medical funding. Mr. Chilton responded that there just was not enough funding to satisfy all the needs and desires of the budget and given the benefit was not subject to the inviolable contract, funding was not provided.

Representative Kay made a comment and expressed concern over a budget that focuses on only what can legally be done and does not invest or make additional effort to help the professionals that run the state. Teachers are not going to be happy if their retiree health insurance is not funded and employees in this Commonwealth hope for a job where there is medical insurance. Medical insurance is expensive and will likely continue to get more expensive, but the General Assembly should hope to provide health insurance for everybody that works for the Commonwealth regardless if it is in the inviolable contract.

In response to a question from Mr. Chilton regarding member contributions and state/employer matching contributions for cash inflows, Mr. Barnes stated that payroll is not going down, but that the lowered totals in FYTD 2018 is attributed to timing and posting of contributions.

Investment, Cash Flow, and Budget Update

David Eager, Interim Executive Director, and Rich Robben, CFA, Interim Executive Director, Kentucky Retirement Systems provided the update. Mr. Eager opened with some general remarks, most notably the continued improvement in cash flow, recent asset growth due to strong investment markets, and the considerable increase in future employer contribution rates as a result of the board's adoption of more realistic assumptions. Regardless, the challenge is real and will take a long term commitment to tackle.

Mr. Robben reviewed recent investment trends and indicated that recent strong performance had continued into the current fiscal year. As of November 2017, the combined pension fund had returned 5.84 percent, while the insurance fund returned 6.01 percent. Mr. Robben indicated KRS was continuing to see divergence in performance between the underlying systems, primarily driven by a more conservative asset allocation that has been adopted for the Kentucky Employees Retirement System (KERS) nonhazardous and State Police Retirement System (SPRS) pension plans given their current funded status. At a system level, pension returns over the 1-year time frame have ranged from 14.3 percent (for KERS nonhazardous) to 16.5 percent (County Employees Retirement System (CERS) nonhazardous). The insurance fund has less divergence, with most plans returning approximately 16.5 percent over the trailing 1-year.

In response to a question from Representative Miller regarding the divergence of returns, Mr. Robben stated that the CERS and insurance plans are being invested fully as the Board and staff would desire. The KERS and SPRS plans cannot quite tolerate some of illiquidity or risk, so staff has to adjust the allocation of those plans, or tone down the portfolio from a risk standpoint. CERS is what staff would consider the flagship fund of staff's investment efforts.

Mr. Eager provided a cash flow update and compared the first five months of FY2018 with the prior year. He used the KERS non-hazardous fund to highlight total cash inflows, outflows, asset gains or losses, and net changes in plan assets. Thus far in FY2018, while in most cases total benefit payments have risen slightly, all ten pension and insurance plans have experienced a net gain in cash flows. Mr. Eager referenced similar cash flow data provided for the insurance plans and stated the trend was pretty similar to the pension funds, but at a much smaller scale. He reminded the board that the insurance fund were better funded in large part, on average around 60 percent funded.

Mr. Eager reviewed the employer contributions rates incorporated in the executive budget. As a result of the new assumptions utilized in the actuarial process, on average, the employer rates are increasing about 50 percent for FY 2019 versus 2018. For example, the contribution rate for KERS nonhazardous was 49.47 percent in 2018 and will be 83.43 percent in 2019.

In response to a question from Representative Simpson, Mr. Eager referenced the KRS Summary Annual Financial Report (SAFR) and highlighted the allocation of employer contribution rates for the KERS nonhazardous plan. If the plan were fully funded, the contribution rate would be 7.45 percent for pension and 2.7 percent for insurance. The remaining portion, 72 percent of pay, when pension and insurance are combined, is the cost of paying off the unfunded liability. In addition, if looking at cost per tier, the normal cost for Tier 3 for pensions is 2.26 percent.

In response to a question by Senator Bowen regarding current market expectations, Mr. Robben stated the KERS plan was indeed allocated more conservatively, meaning it has less stock investments and more bonds. But, even for the more healthy funds, KRS is looking to peel back, or reduce their exposure to stocks. In fact, in July, when changes were made to the investment return assumption, that was in part due to a revised and new asset allocation. Over the next few months, staff will be moving from what used to be an allocation of roughly 63 percent stocks, down to roughly the mid-40 percent.

With no further business, the meeting was adjourned.