PUBLIC PENSION OVERSIGHT BOARD

Minutes

November 26, 2018

Call to Order and Roll Call

The 8th meeting of the Public Pension Oversight Board was held on Monday, November 26, 2018, at 1:00 PM, in Room 154 of the Capitol Annex. Representative Jerry T. Miller, 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, Christian McDaniel, Gerald A. Neal, and Dennis Parrett; Representatives Ken Fleming, DJ Johnson, James Kay, Arnold Simpson, and Russell Webber; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, and James M. "Mac" Jefferson.

Other Legislators attending: Representative Derrick Graham.

Guests: David Eager, Executive Director, and Karen Roggenkamp, Deputy Executive Director, Kentucky Retirement Systems; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement Systems, and Edward Koebel, EA, FCA, MAAA, Cavanaugh Macdonald Consulting, LLC; and Donna Early, Executive Director, Judicial Form Retirement System.

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

Approval of Minutes

Representative Kay moved that the minutes of the October 22, 2018 meeting be approved. Senator Bowen seconded the motion, and the minutes were approved without objection.

Actuarial/Financial Update – Kentucky Retirement System

David Eager, Executive Director, Kentucky Retirement Systems (KRS) discussed the plans' recent actuarial valuations. Measured by funding status, three of the five pension retirement funds saw improvement, while two fell slightly. Altogether, the combined funded level of the pension funds fell by just 7 basis points, compared to a 500 basis point drop the prior year. The insurance funded levels increased significantly. While projections on the pension side are positive, caution should be given, since contributions are based on a percent of payroll model, with the Kentucky Employees Retirement System (KERS) experiencing a 3.9 percent decline in payroll.

Mr. Eager reviewed the basis of which the June 30, 2018 valuations were conducted. No assumption changes have been made since the 2017 valuations. He reviewed recent legislation and benefit changes that were incorporated in the process, including HB 185, HB 200, HB 265, and HB 362. SB 151 will not be included in the valuation until the courts make a final ruling, but staff are prepared to implement. The closed amortization period continues to drop a year with each valuation and is currently 25 years.

Mr. Eager discussed valuation results. Investment returns ranged from 7.4 percent to 9.3 percent, with the lowest being the KERS nonhazardous and the highest being some of the health insurance funds. In total, plan assets grew $410 million more than expected, with $279 million in pension and $131 million in insurance funds. All five insurance plans showed funding level improvements, with favorable premiums experience and increased member contributions leading to a decline of $0.91 billion in the unfunded liability. The pension funds combined unfunded liability increased by $0.46 billion, caused primarily by lower payroll and higher retirements. Results showed that the KERS and State Police Retirement System (SPRS) hazardous pension plans were becoming more stable, largely due to additional general fund appropriations received in 2017 and 2018. Mr. Egers discussed changes in active membership across all plans and said this was due to covered payroll declining or remaining flat. Maintaining or increasing KERS nonhazardous contributions is critical. The plan has $2 billion in assets, covering approximately two years of benefit payments.

In response to a question from Representative Miller regarding specific areas where a decline in active membership is occurring, Mr. Eager identified universities as an employer that is outsourcing more. Karen Roggenkamp said that, with more retirements than expected, a lag in hiring replacements could be a driver.

In response to questions from Senator Bowen regarding County Employees Retirement System (CERS) hazardous membership and payroll growth, Ms. Roggenkamp stated that CERS did have a slight decline in hazardous members. Regarding a comparison of payroll growth, Mr. Eager stated that CERS did not see payroll growth decline like KERS, however it only grew 0.6 percent compared to their assumption of 2 percent.

In response to questions from Senator Higdon about level dollar funding, Mr. Eager said that the declining payroll growth is leading to fewer contributions, given they are paid on a percent of payroll method, which is causing further funding issues. Senator Higdon suggested KRS further educate the Public Pension Oversight Board (PPOB), and Mr. Eager noted an upcoming presentation in December, where KRS will be accompanied by the systems actuary.

In response to Senator Bowen's earlier question regarding the decline in the hazardous membership, Senator McDaniel referenced recent General Assembly action that reduced or eliminated the requirement for employers to pay pension contributions on certain exempted retirees. Legislators were cautioned of potential issues, which included not only a lack of contributions, especially as the exempted group has been expanded, but also a shortage of new officers as a result of employers instead hiring retired officers.

In response to a question from Mr. Chilton regarding level dollar funding, Mr. Eager stated it was fair to say that, if actual payroll had remained flat, KRS would have received funding close to a fixed level dollar amount.

Mr. Eager discussed comments from the systems actuary, GRS Consulting, with regards to the valuation. GRS stated it was imperative for the state and participating employers in the systems to contribute the actuarial determined contribution every year in order to improve the systems' financial security. GRS suggested that KRS should investigate an alternative method of allocating the amortization cost to participating employers that is not associated with covered payroll.

Ms. Roggenkamp reviewed a breakdown of the unfunded accrued liability (UAL) and funding ratios for each system compared to FY 2017. Compared to the prior year, the total pension UAL increased slightly, while the insurance plans total UAL significantly declined. The combined UAL across both pension and insurance dropped by $0.45 billion. A comparison of funding ratio showed a slight decline for pensions and an increase for insurance.

In response to a question from Representative Miller regarding the systems funding levels bottoming out, Mr. Eager stated that the improved contribution rates, notably in KERS NH, will be a positive factor, but how the plans perform from an investment perspective will also dictate outcome.

Ms. Roggenkamp reviewed recommended employer contribution rates from the 2017 and 2018 valuations, compared to the FY2019 budgeted rates. Pension contributions had slightly increased in the 2018 valuation, while insurance rates had dropped. Certain quasi-KERS nonhazardous agencies had remained at the 2018 budget rate of 49.47 percent. HB 362 had capped the CERS contribution rates to no more than a 12 percent increase annually.

Ms. Roggenkamp reviewed the results of a sensitivity analysis that is included in the valuation process for both the pension and insurance funds to measure how funding and contribution rates are impacted by changes in the discount rates and payroll growth assumptions.

Ms. Roggenkamp reviewed trends within the two largest plans, KERS and CERS nonhazardous. Benefit costs have declined; Tier III normal cost rates were much lower than Tier I. Active member contributions help pay for retiree benefits and, in both KERS and CERS, there is a trend of active membership declining or remaining flat, while the retired membership continues to grow. Retirees represented 73 percent of the existing UAL of KERS, while the plans' active to retired ratio is 0.76. While not as significant, CERS is moving in a similar direction, with 59 percent of the liability represented by retirees and a 1.32 active member to retiree ratio.

Ms. Roggenkamp reviewed a chart of payroll growth for the past 10 years in the CERS and KERS nonhazardous funds. In 2018, the actual payroll growth for KERS nonhazardous was -3.9 percent versus an assumption of 0.0 percent. In CERS, payroll growth for CERS nonhazardous was 0.6 percent, but still below the assumption of 2.0 percent.

In response to a question from Senator McDaniel regarding the active retiree ratio for KERS nonhazardous membership, Mr. Eager agreed that Tier II and Tier III members were not creating much unfunded liability, which was part of differential. However, he said that everyone who is retired currently most likely falls into the Tier I structure. For the near future, as more Tier I members retire, the trend will likely continue.

Ms. Roggenkamp provided projections for the KERS and CERS nonhazardous plans. If all the assumptions were realized, at the end of 20 years, the KERS nonhazardous pension plan was projected to be 69 percent funded, and the CERS nonhazardous pension would be 82 percent funded. On the health insurance side, the KERS nonhazardous insurance plan would be 94 percent funded, and the CERS nonhazardous insurance plan would be 84 percent funded.

In response to a question from Senator Bowen regarding at what funding level a plan is considered healthy, Mr. Eager stated, that in his opinion, a healthy plan would be 100 percent funded. Some in the industry would point to 80 percent as healthy, but most actuaries would still say fully funded is the goal.

Mr. Eager provided a cash flow update and began by discussing some early trends for FY 2019. Combined pension plans saw an increase in value of $298 million in the first quarter of FY 2019. Within the KERS funds, KERS pension plans are benefiting from the higher contribution rates and the plans have positive cash flow without investment income or asset returns. Approximately $30 million in contributions were lost due to quasi agencies only paying the prior year's rate. On the CERS side, assets increased for the quarter, but investment gains and income are driving the growth. Without investments, cash flow was negative; the 12 percent employer contribution phase was the driver.

Mr. Eager reviewed a summary of active membership versus retirees for the nonhazardous funds and SPRS. In all three plans, active membership declined while the number of retirees increased. The decline in active membership was driving lower payroll growth, even negative with regards to KERS, and below the assumed payroll growth for the two largest nonhazardous funds.

In response to a question from Representative Miller regarding the timeframe considered when evaluating the payroll growth assumption, Ms. Roggenkamp stated KRS considered the last 10 years of payroll growth. Mr. Eager added that future expectations were also considered when setting assumptions.

Mr. Eager reviewed cash flow information for each of the pension plans that included cash inflows, cash outflows, net cash flow before gains/losses, and change in net plan assets for the FY ended on June 30, 2018, compared to June 30, 2017, and the quarter ended on September 30, 2018 compared to September 30, 2017.

In response to a question from Representative Miller as to actuarial back loading, Mr. Eager stated that would likely be determined by funding, but hoped there would be no more actuarial back loading.

In response to questions from Senator McDaniel regarding the permanent pension fund and any payouts, Mr. Eager deferred the question to Mr. Chilton. Mr. Chilton stated that he believed there was a contribution made of the permanent pension fund into the plans, which was part of the increased contribution in FY 2018. Ms. Roggenkamp added that KRS received some direct appropriations above the ARC in 2017 and 2018, but she did not believe any permanent pension fund payments were received. Mr. Chilton said he would ask budget staff to review.

In response to comment from Senator Higdon regarding unrealistic assumptions, Mr. Eager responded that, in his opinion, using more appropriate assumptions would have produced higher contribution rates, which even if not fully funded, would likely have resulted in higher contributions.

Actuarial/Financial Update – Teachers' Retirement System

Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement Systems (TRS) and Edward Koebel, Consulting Actuary, Cavanaugh Macdonald Consulting, LLC presented a financial and actuarial update.

Mr. Barnes reviewed results from the recently completed actuarial valuations, comparing funding values and unfunded liabilities to the prior year. Funding levels of both the pension and insurance funds had improved from 2017, largely driven by strong asset growth. Mr. Barnes provided results for the accounting based, Governmental Accounting Standards Board (GASB), valuations and called attention to a significant funding improvement on the pension side. The improved funding was largely the result of the additional funding received by TRS and the current budget commitment.

In response to a question from Senator McDaniel regarding the GASB valuations, Mr. Barnes said the additional contributions received, along with the General Assembly's commitment to pay the full contribution in the current budget, have resulted in the TRS GASB funding values increasing by 20 percent.

Mr. Barnes provided a quarterly investment performance update as of September 30, 2018. The funds' performance for the first quarter of the fiscal year was 3 percent, while the trailing 1- and 10-year returns were 8.89 percent and 8.79 percent respectively. Over a longer time frame, the fund had returned 6.48 percent over the past 20 year period, which includes the dot com bubble and the great recession, and 8.45 percent (compounded gross return) for the last 30 years.

Mr. Barnes reviewed first quarter cash flows for the pension plan for the current fiscal year compared to 2018. The additional funding received has reduced the need to sell assets and improved cash flow. Strong investment returns, both realized and unrealized, have resulted in asset growth from the prior year.

Edward Koebel, Cavanaugh Macdonald Consulting, LLC, discussed key findings from the 2018 valuations and a review of key economic assumptions for TRS. He reviewed several key findings from the 2018 valuations. There was a strong investment return, along with increased funding have resulted in funded assets of approximately $20 billion. There was negative cash flow, but it is not abnormal for a mature plan like TRS to have negative cash flow as long as the ratio of contributions to benefit payment is within reason. TRS had received at least 97 percent of the additional required funding since fiscal year 2017, with $475 million received in FY 2018, and the current biennium budget has included effectively full funding. The additional funding received is shown in the improved funding of the plan. The funding ratio increase for the fourth year out of the last five, while the unfunded actuarial accrued liability (UAAL) remained at $14.3 billion and is scheduled to be paid off completely over the remaining 26-year period at an annual payment of approximately $872 million.

In response to questions from Senator Higdon and Senator McDaniel regarding the UAAL payment, Mr. Koebel stated that the $872 million dollar payment is calculated based upon the funding policy that TRS has in place. The TRS board' funding policy took the 2014 existing, legacy UAAL amount and began amortizing it over a 30-year period, while each year after any new gain or loss is paid off over a 25-year period. Thus, the $872 million is the accumulation of the UAAL payment.

In response to a question from Senator Higdon regarding the amortization period, Mr. Koebel confirmed that TRS utilized an open amortization period, which effectively reamortized the debt each year. However, the board moved to a closed period in 2014, and each additional year is also on a closed period.

In response to a follow up question from Senator McDaniel, Mr. Barnes clarified that the $872 million is not an additional contribution required above what is currently included in budget. A portion of the statutory rate was contributed and applied to a portion of the $872 million payment. However, not all was covered, so TRS began asking for an additional contribution above the statutory rate to fully fund the $872 million requirement. Mr. Koebel stated that the full contribution requirement consists of two pieces: (1) a normal cost, which is annual accruals for active members' benefits and (2) the amortized payment for UAAL, which in this case is $872 million. The normal cost and a portion of the UAAL payment were covered by statutory contributions, but an additional amount of a $500 million is needed to completely fund the entire actuarially determined rate.

In response to a follow-up question from Senator McDaniel regarding how much additional money TRS would be asking for in the next budget biennium, if experience was similar to assumptions, Mr. Barnes and Mr. Koebel referenced the past couple of budget cycles and pointed out that the total required contribution was fairly stable. While future experience is tough to forecast, Mr. Barnes and Mr. Koebel indicated the current amount should be a good guess, if existing assumptions were met.

Mr. Koebel reviewed key economic assumptions, including the investment rate of return and payroll growth rate. He reviewed TRS' most recent experience study conducted as of June 30, 2015, which served to set the current assumptions. The TRS board of trustees and Cavanaugh Macdonald Consulting, LLC, conduct an experience study every five years to review current economic and demographic assumptions and recommend modifications where appropriate. The Actuarial Standards of Practice guides the development of assumptions. The study also considers current actuarial methods.

Mr. Koebel discussed the price inflation assumption, which is the building block upon which the investment return and payroll growth assumptions are based. During the 2015 study, the board considered historical consumer price index increases (CPI), as well as forward-looking estimates, before settling on an assumption of 3 percent, which was a reduction from 3.5 percent previously.

In response to a question from Representative Miller regarding changing assumptions between the experience studies, Mr. Koebel stated that assumptions tend to remain static and generally no changes are made for five years. Mr. Barnes said that, every two years, when TRS goes through budget requests, the actuaries review the past actual system experience, which could result in an increased budget request for the next two-year period.

Mr. Koebel discussed the review of the systems' investment return assumption. His firm's approach incorporated capital market assumptions from the systems' consultant and the board-approved target asset allocations to model a range of expected returns over the next 20 to 30 years. Median expected return at the time was just over 7.5 percent, which resulted in TRS maintaining their assumption at 7.5 percent.

Mr. Koebel summarized TRS' most recent experience study in the context of a review of the systems' wage inflation (payroll growth), noting that the assumption prior to 2015 was 4 percent, which was 50 basis points above the price inflation rate. A chart showed an average price inflation and wage inflation over the last 50 years and stated that, given the reduction in the inflation rate, the board adopted a recommendation to reduce the wage inflation assumption to 3.5 percent.

Representative Miller referenced the PFM study, which identified actuarial back loading as a significant factor in accumulating unfunded liabilities, and distributed a summary of TRS payroll growth over the past 20 years, which fell short of the system's assumption. Mr. Barnes said that the PFM report identified actuarial assumptions and actuarial back loading as both causes for the growth, along with previous budgets that were not able to support the full funding requests.

Mr. Koebel discussed potential causes of UAAL, which included (1) granting initial benefits or granting benefit increases for services already rendered, (2) actual experience, which is less favorable than assumed, (3) contributing less than the full actuarial contribution rate, and (4) changes in actuarial assumptions or methods. Mr. Koebel discussed how plans amortize UAAL and how it has become a major component of the actuarial required contribution rate in recent years. Plans have several options, which may include one base or multiple bases, amortization periods that are open or closed, different time periods, and whether the payment is calculated on a level dollar or level percent of pay method.

Mr. Koebel summarized the differences between the level dollar and level percent of pay methodologies. Level dollar is more like a traditional mortgage, which requires more dollars today but the same total payment across the time period. Level percent of pay requires fewer dollar today, but as payroll grows, so will the total dollars in contributions. Utilizing a level percent of pay model is more consistent and better for budget purposes because the hope is that payroll will continue to grow over a period of time.

Representative Miller commented that this expectation is the reason why the system is where it is. The system has assumed 3.5 and 4 percent payroll growth for the past ten years, while actual payroll has just been 1.3 percent.

Mr. Barnes said that level percentage of pay is the most common method of amortizing the unfunded liability. TRS anticipates inflation, and unlike KRS, it believes membership will continue to grow as the population grows and teachers are needed for the classrooms. As a result, TRS allocates amortization payments according to that increase in payroll growth and largely inflation. Utilizing a level percent of pay model does not put undue pressure on the current taxpayer.

Representative Miller said that hope is not a plan, and the committee must deal with the facts.

Senator Higdon said that there are several reasons for the growth in UAAL. In a 2014 study conducted by Flick Fornia, a consultant estimated that approximately 20 percent of the growth was due to funding, while about 50 percent was the result of changing assumptions and reamortizing the debt each year.

Mr. Barnes said that in 2008 TRS saw payroll growth of 7.23 percent. It decreased to 1.97 percent in 2009 and over a 20-year period the average is 3.08 percent.

In response to questions from Mr. Jefferson in regards to distinguishing between wage inflation, price inflation, and cost of living adjustments (COLA) and each one's potential impact on cash flows from state and funded status, Mr. Koebel stated that the COLA assumption is set in statute, while the price inflation is provided just to give more detail to the building block approach used in developing the investment return assumption. It is typical for wage inflation to be higher than price inflation, given seniority, merit, and promotional increases in compensation.

In response to a follow-up question regarding how much weight is placed on consultant capital market assumptions, Mr. Koebel identified time horizon as a consideration that is made. Consultants tend to model the next 5 to 10-year horizon, which is why they are typically a little shorter than the actuary.

In response to questions from Mr. Chilton regarding assumed individual salary increases, Mr. Koebel stated the valuation assumed member increases, and the assumption was slightly higher than inflation, which represented positive reviews, merit increases, and promotions. In regards to recent changes, the individual salary increases assumption was reduced during the 2015 experience study, largely to reflect the lower inflation assumption. In regards to the increase in the assumed real rate of return above inflation in 2015, the system was expecting higher real returns. The changing asset allocation of TRS and its transition into higher returning, alternative asset classes, such as private equity and real estate, is a driver for the increased expectation.

Senator McDaniel urged TRS to consider alternative payroll growth assumptions and approaches to evaluating. Teachers are a somewhat unique population, and membership and individual salaries will grow as population grows. He suggested considering an assumption that would still reflect the unique population of teachers, while also not relying on such growth in population or total payroll.

Mr. Barnes said that several factors should be considered in setting assumptions. If payroll growth is lowered, it would mean actuaries would also assume lower individual salaries, and with that, the retirement benefits will also be lower. This could potentially create a situation where the UAL is actually understated due to individual salaries being higher than expected.

Representative Miller said that TRS has been understating the unfunded liability by utilizing a payroll growth rate above actual. The General Assembly desires to fully fund pensions, but to do that requires legislators to know the facts. Mr. Barnes said that TRS is trying to forward the correct information.

In response to questions from Senator Bowen regarding changes SB 151 would make to the amortization of UAAL, Mr. Barnes stated that SB 151 would make payroll growth irrelevant in FY 2021 because it would require level dollar. Moving to the level dollar method would result in more contributions in the short term.

Mr. Barnes discussed the previous month's PPOB meeting. The TRS board has decided to move ahead with voluntary electronic voting and is planning to have it implemented by December.

Actuarial/Financial Update – Judicial Form Retirement System

Donna Early, Executive Director, Judicial Form Retirement System (JFRS), discussed the judicial and legislator pension funding progress and state contributions. She compared each fiscal year dating to 2014 for both the defined benefit and hybrid cash balance plans. Over the five-year period, the plans' funded status continued to increase and the state contributions continued to decrease.

Ms. Early reviewed cash flow for the judicial and legislator plans, discussing cash inflows, outflows, net cash flow before asset gain/losses, realized/unrealized investment gains/losses, and net plan assets with comparison of the fiscal years since FY 2016/2017. JFRS is unique in that there is never more than the allowable membership, and the only individuals eligible are members of one of the state's four courts or a member of the General Assembly. There were no state appropriations for the legislators' plan for the current budget biennium.

Representative Miller asked the members to not forget that the PPOB's required list of recommendations to the General Assembly will be reviewed at the PPOB December meeting. He directed members to give their proposed recommendations to staff.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, December 17, 2018.