

PUBLIC PENSION OVERSIGHT BOARD

Minutes

December 17, 2018

Call to Order and Roll Call

The 9th meeting of the Public Pension Oversight Board was held on Monday, December 17, 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, Christian McDaniel, Gerald A. Neal, Dennis Parrett, and Wil Schroder; Representatives Ken Fleming, DJ Johnson, James Kay, Arnold Simpson, and Russell Webber; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Other Legislators Attending: Representatives Derrick Graham and Jim DuPlessis.

Guests: David Eager, Executive Director, and Katherine Rupinen, General Counsel, Division of Advocacy, Kentucky Retirement Systems; and Danny White, Gabriel, Roeder, Smith & Company.

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

Approval of Minutes

Representative Fleming moved that the minutes of the November 26, 2018 meeting be approved. Representative Johnson seconded the motion, and the minutes were approved without objection.

Agency Participation Issues

David Eager, Executive Director, Kentucky Retirement Systems (KRS) began his comments by commending the legislature for the additional funding received and pointed out that KRS had received an additional \$185 million in contributions during the recently completed 2018 fiscal year. In addition, with the passage of HB 200 and an employer contribution rate of 83 percent for the Kentucky Employees Retirement System (KERS) nonhazardous plan, the plan anticipates a positive cash flow of \$300 million without considering investment returns. However, Mr. Eager noted the significant increase in rates did come with some negative impact, most notably relating to quasi-state (quasi) agencies that could not afford to either remain or exit the plan. He indicated KRS staff had

investigated many options and were proposing three to the Public Pension Oversight Board (PPOB) for consideration.

With regards to employer participation, Mr. Eager provided some background and reviewed previous legislative enactments relating to the matter. He noted that HB 62, which was passed in 2015, initially created the process by which certain agencies could cease participation and leave KRS. The process according to HB 62, which could take up to 18 months, started with an application, a cash deposit to cover needed actuarial analysis, and initial approval by the KRS board. Next, an actuarial valuation was conducted using the assumed rate of return, a cost was determined, the agency made a decision to leave or stay, and the agency could pay the cost as a lump sum or in installments over a 20-year period. In 2017, HB 351 adjusted the process by establishing a benchmark for the actuarially assumed interest rate used to calculate the cost estimate and by removing the installment payment option for agencies. In 2018, HB 362 froze the contribution rate for quasi agency employers in KERS nonhazardous at 49.47 percent for FY 2019 (versus 83.43 percent for every other employers) and also created a phase-in period for employers of the County Employees Retirement System (CERS) plan. Mr. Eager also discussed a 2018 legislative proposal that did not become law that would have offered quasi agencies a 40-year interest-free installment plan for paying the costs to cease participation.

Mr. Eager discussed the first of three key aspects to the KERS nonhazardous funding problem. First, he noted that contributions are based on a percent of payroll calculation, which has led agencies to outsource, not replace departing employees, and have retirements that exceed new hires. As payroll has declined, so have contributions received, which then leads to a higher contribution rate and more incentive for employers to look for ways around paying the increasing contribution rate. Danny White, Gabriel, Roeder, Smith & Company, the KRS consulting actuary, reviewed recommended and actual budgeted contribution rates from 1993 through 2019 for the plan, noting that, during this period of rising rates, the active member populations had declined significantly. Mr. White indicated that, in a situation like this, where rates are climbing, but covered payroll is declining, using a percent of payroll mechanism to collect contributions is not adequate. Mr. White recommended the legislature enact a fixed-dollar allocation and stated that a similar provision had been included in SB 151.

Second, Mr. White stated that another key to the KERS nonhazardous funding problem was the fact that a majority of the unfunded actuarial liability (UAL) covered retiree benefit payments. He reviewed the unfunded liability of both the total KERS nonhazardous fund and the smaller group of quasi agencies, where retiree benefits accounted for 69 percent and 59 percent of the UAL, respectively. He stated that the smaller group of quasi agencies accounted for approximately 20 percent of the total KERS nonhazardous UAL. Mr. White and Mr. Eager both emphasized this was related to current retiree payments, which presents a dilemma the state cannot legislate its way out of. Mr.

White reviewed a chart of active versus retired members dating back to 2010, which showed the declining active membership base referenced earlier in the meeting.

Third, Mr. White stated the KERS funding problem is putting pressure on quasi agencies that cannot afford to pay the higher contribution rates and are being faced with the option of bankruptcy. Mr. White noted two major problems that are caused by bankruptcy. First, contributions paid by the employer and employees of the agency are lost. Secondly, the unfunded liability that is associated with the agency must be covered by the remaining employers, which then further drives up future contribution rates. Mr. White provided an example of Seven County Services as an employer that exited the plan through bankruptcy.

Mr. Eager focused the discussion on quasi-state agencies and the dilemma they are facing. Many quasi agencies had told KRS they could not afford the 83.43 percent contribution rates, but also could not afford cessation as outlined by HB 351. Mr. Eager stated that the state wants the services of these quasi agencies to continue, and most agencies would like to remain in KRS.

In response to a question from Senator Bowen regarding new agencies joining KERS, Ms. Rupinen, General Counsel, Division of Advocacy, KRS stated she is not aware of any moratorium restricting new agency participation, but very few are seeking to join given the cost of contribution rates.

Mr. Eager continued the discussion by defining and providing a list of the 118 quasi-governmental entities participating in KERS. He noted they are not defined by statute, but generally, represent services created by government, tend to maintain separate legal status, and often are governed by board members who are appointed by government officials. He stated that depending on how these entities are defined, there could be up to 600 quasi agencies in KERS and CERS, including health departments, mental health units, universities, housing authorities, advocacy centers, and other agencies.

Mr. Eager and Mr. White offered three recommended options for addressing the participation issues facing the quasi employers. Mr. Eager indicated that staff had considered all options and tried to be creative, but in the end, the recommended options were fairly straightforward.

Option 1 would require quasi-governmental agencies to resume paying the actuarially determined contribution rate (currently 83.43 percent) after the one year reprieve given in FY 2019. The advantage of this option would be that all employers are paying the same rate, but disadvantages include potential bankruptcies and the state losing services provided by quasi agencies. Mr. White stated that this option would likely result in less total contributions received compared to having all the quasi agencies paying 49.47 percent, given the likelihood of bankruptcy or cessation.

Option 2 would keep the contribution rate for quasi-government agencies at a separate, lower rate (currently 49.47 in FY 2019), while also converting the contribution required for amortizing the unfunded liability to a fixed dollar payment rather than a percent of payroll. Many agencies have indicated this option would allow them to continue operating, while converting the amortization to a fixed dollar would remove the risk associated with a declining payroll.

In response to a question from Senator Bowen, Mr. White stated that once a policy was established, and a lower contribution rate determined, the rate established would be used to calculate the dollar amount owed by each quasi agency. The employers would be invoiced for dollar contributions rather than as a percent of their payroll.

In response to a question from Representative Miller regarding amortization periods, Mr. White stated that option 2 did not include any change to the length of the amortization period. However, some of those decisions would be determined by policy. A policy of charging a fixed rate would make the amortization period irrelevant as employers would pay that same rate, expressed in total dollars, until the fund is 100 percent funded.

In response to a question from Representative Fleming regarding an analysis or assessment of value, Mr. Eager indicated that KRS was not in a position to assess the value or impact of the underlying quasi agencies.

In response to questions from Mr. Harmon, Mr. White indicated that, for administrative purposes, the fixed contribution rate would apply to each agency. Effectively, that fixed rate would then be used to calculate a dollar amount due. A portion of the dollar amount invoiced would be used to pay the normal cost for active employees, while the remainder would be applied to the employers outstanding UAL.

Mr. White noted that option 2 would represent a policy decision for the quasi agencies to pay less, thus a disadvantage is that additional funding would be required. Using the current rate of 49 percent that quasi agencies are paying, the total shortfall is approximately \$132 million, which could be made up through future budgets or higher contribution rates for the remaining employers. Mr. White referenced a slide which provided detail to the estimate of \$132 million in contributions.

In response to questions from Senator McDaniel, Mr. White stated that other agencies or the general fund would have to make up the difference if quasi agencies continue to pay just 49 percent converted to a fixed dollar payment.

Option 3 would keep the contribution rate for quasi-government agencies at a reduced rate (currently 49.47 in FY 2019), but also require a “soft freeze” of benefits. Mr. White commented that this option would be subject to future litigation, and there could be

workforce and financial implications as well. He noted that some might argue this option represents a shared solution, which asks Tier 1 and 2 members to sacrifice some benefits, but it is still a better option for members than having their employer filing bankruptcy or ceasing to participate.

In response to questions from Mr. Harmon, Mr. White stated Tier 1 and 2 members would not lose any current benefits accrued under this option, but would then be transitioned to Tier 3 for future service. He noted this could trigger one of the potential disadvantages, where Tier 1 employees decide to just go ahead and retire. If employers decided to not replace retiring members, not only would less contributions be received, but there could be workforce issues.

Mr. Eager reviewed two recommendations that had been approved by the KRS Board of Trustees. First, the board recommended that current provisions of HB 62 and HB 351 not be altered. Secondly, the board recommended adopting the option 2 approach to addressing the quasi agency participation issue. He stated that none of the options were optimal, but option 2 results in the least amount of risk of bankruptcy and payroll decline.

Senator Bowen recognized and welcomed Representative Jim DuPlessis, who will serve as the new Co-Chair of the PPOB in 2019.

In response to a question from Representative DuPlessis with regards to requiring employers to pay contributions on outsourced workers, Mrs. Rupinen indicated that the option had been discussed in years past, and she believed that KRS would not be opposed to it.

Mr. White added that KRS does not currently know how many agencies are using contract employees. He indicated that requiring contributions for contract employees could be an option if payroll could be identified to make sure those employers were faithfully making those contributions. Mr. White also added that it was his understanding that, in some cases, employers are reducing head count through other sources, such as technology, and not utilizing contract employees. Mr. Eager added that KRS would like to do a follow-up with a more thorough examination.

In response to a question from Representative DuPlessis regarding how option 2 would work for an employer looking to add employees, Mr. White explained that the normal cost component would act as a variable rate and would be paid for each employee. The dollar amount that would serve to pay down the unfunded liability would then be shared across all employees. So, employers who wanted to add employees would not have to pay the full rate on every new employee, just the normal cost for that additional employee.

In response to questions from Mr. Chilton, Mr. White agreed that options 1 and 2 would impact employer funding, while option 3 did consider a change in benefits for active Tier 1 and 2 members moving into Tier 3 on a going forward basis. In response to follow up questions regarding how option 2 might work for other plans, such as CERS and the Teachers' Retirement System, Mr. White noted that the CERS plan was not funded with general fund appropriations and creating a situation where some employers paid less than others could create some real inequality, since the difference would have to be paid by the rest of the employers. So, in the case of CERS, it is more paramount that the rate be the same across all employers.

Representative Kay made a comment regarding Representative DuPlessis' earlier question about outsourcing, and noted that he had previously filed a bill addressing the matter and does believe there are a lot of state jobs that are being contracted in order to avoid the pension costs, which is not helping the unfunded problem.

In response to a question from Senator Bowen regarding how many employers would be willing to pay benefit contributions on contract workers that are not receiving the benefits, Mr. White stated that a partial amount could be collected for the unfunded liability.

Recommendations

Senator Bowen reviewed the 2018 PPOB recommendations. The recommendations included:

- PPOB staff should research and present information to the board regarding the level of compensation paid to retirement system board members in Kentucky and nationwide.
- The PPOB should study issues regarding mandates for system asset managers to abide by the CFA Code of Conduct and whether the SEC Code of Ethics should be used as an alternative mandate.
- Legislation should be enacted, similar to provisions included in BR 11 that has been prefilled for the 2019 Regular Session, to allow KRS to conduct electronic trustee elections, to synchronize CERS trustee elections to save administrative costs, and to make other housekeeping changes recommended by KRS.
- Legislation should be enacted, similar to the provisions included in BR 202 that has been prefilled for the 2019 Regular Session, to void the retirement of an elected official who following retirement returns to the same office within 12 months.
- Legislation should be enacted to convert the funding formula of the KRS systems so that each agency pays a set dollar amount.
- The General Assembly should consider auto-enrolling future public employees into Kentucky Deferred Compensation with a 1 percent employee contribution.

- The General Assembly should enact legislation to address funding/participation concerns of quasi-governmental employers.

Representative Johnson moved that the 2018 Recommendations be approved. Representative Miller seconded the motion, and the recommendations were approved without objection. J. Michael Brown abstained.

Representative Simpson moved that the draft PPOB 2018 Annual Report be approved subject to the addition of the recommendations just approved and any technical edits needed. Representative Johnson seconded the motion, and the draft PPOB 2018 Annual Report was approved without objection.

Senator Bowen recognized with resolutions the legislators leaving PPOB. Those mentioned were Representative Fleming, Representative Kay, and Representative Simpson. Senator Higdon recognized Senator Bowen with a resolution along with comments from Representative Miller.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, January 28, 2019.