# PUBLIC PENSION OVERSIGHT BOARD

## Minutes of the 2nd Meeting
## of the 2019 Interim

## March 25, 2019

### Call to Order and Roll Call

The 2nd meeting of the Public Pension Oversight Board was held on Monday, March 25, 2019, at 1:00 PM, in Room 154 of the Capitol Annex. Senator Jimmy Higdon, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, and Sharon Mattingly.

Other Legislators Attending: Representative Derrick Graham.

Guests: Gary Harbin, Executive Secretary, Teachers' Retirement System; Brad Gross, Jennifer Black Hans, and Bo Cracraft LRC Staff.

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

### Approval of Minutes

Representative Pratt moved that the minutes of the February 25, 2019 meeting be approved. Senator Parrett seconded the motion, and the minutes were approved without objection.

Senator Higdon invited Gary Harbin, Executive Secretary, Teachers' Retirement System (TRS), to introduce himself to the newest members of the Public Pension Oversight Board. Mr. Harbin stated that he is a CPA and has been with the TRS for the past 20 years. He thanked the board and the General Assembly for the legislation that passed this session and stated that TRS should be able to get back into private equity with the passing of Representative Miller's bill. Mr. Harbin stated that private equity is an asset class that returned 19 percent net of fees in 2018, and it will allow TRS with an allocation of 7 percent to keep pace with other pension plans that have an allocation of 15 percent in comparison. Mr. Harbin stated that, most importantly, this is the first budget that has fully funded both the pension and medical plans since he has been with TRS, which allows TRS to invest more freely, it takes care of cash flow needs, and allows the system to be maintained in a more proper fashion.

In response to a question from Senator Higdon, Mr. Harbin stated the only issue he foresees in the upcoming year is moving the assumptions, which TRS will be looking at this year. TRS will look at both the payroll growth and the assumed rate of return, which is looked at every five years. He discussed a study by the National Association of State Retirement Administrators (NASRA).

Representative Miller commented that the most recent NASRA study showed a downward trend on assumed rates and for the median it is 7.25 percent and the average is 7.27 percent. Mr. Miller also mentioned that payroll growth over the last 10 years has been 1.7 percent. Mr. Harbin confirmed that TRS is still using 3.5 percent.

In response to questions from Representative DuPlessis, Mr. Harbin stated that the assumptions should not be changed too often due to asset allocations being based on those assumptions. He also stated that TRS does change the asset allocation on an annual basis so the investments are not impacted by the actuarial assumptions. Answering a follow up question, Mr. Harbin stated that the TRS board and staff has been stable and excellent, with low turnover and some of the lowest administrative costs in the nation with good long term investment performance. He stated that TRS has two investment experts serving on the board and regularly consults other investment professionals. Mr. Harbin stated that the makeup of the board is totally subject to the control of the General Assembly.

In response to questions from Representative Graviss, Mr. Harbin stated the assumptions will be reviewed in 2020. He confirmed that assumptions are reviewed every five years and independent actuarial audits conducted every ten years. In response to a follow up question regarding the timing of the assumptions study after the 2020 budget session, Mr. Harbin stated the adjustments to assumptions are long-term and intended to address the needs of the system for the next 30 years. He also stated that there is nothing that would prevent the Governor or General Assembly from providing more funding for TRS. Representative Graviss asked if TRS could supply the General Assembly with projections beyond one year of what the costs and participants would look like under the current assumptions.

In response to a question from Senator Higdon, Mr. Harbin stated the minimal payment for the 2020 budget is already known because it was based on the 2017 review, which gives the legislators plenty of notice to know if additional funding is required.

Representative Miller commented on assumptions, saying that by using a 3.5 percent payroll assumption when for the last 10 years it was actually 1.7 percent, and by using a 7.5 percent assumed rate of return when the national average is 7.25 percent and trending downward, is not TRS is doing a disservice to its members. He also said that the General Assembly should accept the responsibility for the real shortfall by legislating level dollar funding. Mr. Harbin stated he would also support level dollar funding if it was possible, and that TRS would take additional money if the budget would allow it.

In response to questions from Representative Wheatley, Mr. Harbin explained that state law provides that the actuary sets the assumptions, and the board shall approve the assumptions established by the actuary. During the process to set the assumptions every five years, the board has discussions with and receives input from the actuaries. In response to a follow up question, Mr. Harbin stated that the payroll growth over the last 30 years averaged above 4 percent.

In response to a question from Representative Pratt, Mr. Harbin stated that TRS uses actuaries that are independent, professional actuary firms, just like the CPA firms used for the audit.

**Legislative Update**

Brad Gross and Jennifer Black Hans, LRC Staff, presented the 2019 legislative update. Mr. Gross stated that most of the bills that have passed to date specifically deal with issues of retired reemployed members of the Kentucky Retirement Systems (KRS). The presentation featured bills passed, bills for possible concurrence, bills introduced of note, and all pension bills introduced in the Senate and House.

Mr. Gross started with some background history on retired reemployed members under state law. He stated that, in a 2008 special session, the General Assembly passed HB 1, which made significant changes to breaks in employment and how things are impacted when somebody retires and comes back to work at KRS. Specifically, if a retiree at KRS is reemployed on or after September 1, 2008, there is no second retirement account. Also, the employee does not have to contribute to the systems because he or she is not earning a benefit. However, HB 1 required the employer to continue making the contribution on behalf of the reemployed member and at the established rate in order to help pay down the unfunded liability. In the case of retiree health care, which was provided to retired reemployed members by the retirement systems, state law provided that, if that retiree took health insurance coverage through the systems, the employer was still required to reimburse the system for the cost of that member’s health care. There were also some federal issues in or around 2008, which had to be addressed by state law. Specifically, state law clarified what constitutes a prearranged agreement between the retired reemployed member and the same participating employer from which the member retired. Under this scenario, there is the potential for a voiding of the retirement benefits, meaning that it is as if the employee never retired, and the employee will be required to pay back the retirement benefits that were paid.

Mr. Gross reviewed bills that have passed in regards to KRS retired reemployed provisions. HB 55 creates a legal assumption as to prearranged agreements and specifies the voiding of retirement for an elected official which retires from KRS and is re-elected to the same office within 12 months of retiring. HB 381 relates to retired reemployed police officers at universities. It creates an exemption for the universities so it is not required to pay the employer contribution for pension and retiree health on certain officers reemployed to specific positions that are limited in number.

Senator Higdon commented that at some point the issue needs to be revisited regarding employers of retired officers not paying the full rate. He explained that the systems should still recoup the normal cost.

Mr. Gross continued with HB 419 relating to the process for retired reemployed members and their employers to comply with KRS verification regarding prearranged agreements or employment as an independent contractor. The bill provides that there is no prearranged agreement if the reemployment occurs 12 months or later from the date of the retirement. HB 419 should contribute to reducing paperwork between the parties and KRS.

In response to a question from Representative Miller, Mr. Gross confirmed that HB 381 did not change current state law as it applied to retirees which retain to their local elected positions, for which it does not earn retirement after it retires from a participating agency in KRS.

Ms. Hans reviewed bills passed regarding KRS and TRS housekeeping and the ethical requirements for investment managers. HB 80 relates to KRS housekeeping and permits KRS to use electronic ballots for trustee elections and synchronizes the elections for the two County Employees Retirement System (CERS) trustees. HB 489 relates to KRS and TRS ethical requirements for investment managers and adopts additional conflict of interest provisions. Mr. Gross reviewed SB 107 that passed and provides for the automatic enrollment of state employees in a 401(k) plan administered by the Deferred Compensation Authority.

Mr. Gross discussed HB 358, which had passed both chambers with different versions. HB 358 relates generally to the cessation of participation in the Kentucky Employees Retirement System (KERS) by universities and quasi-governmental entities by a date certain. Both versions also extend the freeze on the employer contribution rate for those quasi-state agencies in KERS already receiving the lowered rate in fiscal year 2018-2019. The reduced rate would be maintained at 49.47 percent of pay in fiscal year 2019-2020.

In response to a question from Representative Wheatley, Mr. Gross stated that the quasi-governmental entities participating in TRS are statutory. When the CERS was created, quasi-governmental entities participated as a voluntary opt in system, but once in, it had to remain in. For KERS, the Governor issues Executive Orders often at the request of the entity to participate and, more recently, final approval is with the KRS board of trustees.

In response to a question from Representative DuPlessis regarding the Senate's version of HB 358, Mr. Gross stated that, if a quasi-governmental employer were to opt back in to KERS, the employer would have to pay 83.43 percent of pay within the next budget cycle absent future action by the legislature.

In response to questions from Representative Graviss, Mr. Gross confirmed with Dave Eager that approximately 9,000 employees in KERS could be impacted by HB 358. In response to follow up questions, Mr. Gross stated that policy issues do exist regarding the absence of an installment period and specifics regarding what enforcement mechanisms KRS would have to ensure timely and continued payments. Representative Graviss commented that these questions concerning the bill could leave KRS and the remaining participating employees holding the bag for the nonpayment.

In response to a question from Representative Miller, Mr. Gross stated that, under current law, if an agency has voluntary cessation, its employees stop participating as of a date certain and the employer ceasing participation pays the actuarial bill as determined by the KRS actuary.

In response to a question from Ms. Mattingly, Mr. Gross stated that under current cessation provisions, whatever an employee accrued to cessation date is still in the system. Under some of the proposals related to HB 358, some employees could elect to continue participating in KERS.

Senator Higdon commented that, if an employer ceases participating in the system, the employee can take another state job and pick up their retirement where it left off.

Mr. Gross discussed in summary fashion SB 41, which passed the House with a House floor amendment extending the rate reduction for quasi-governmental entities, and SB 162, relating to school resource and security officers. Finally, Mr. Gross noted bills that are still pending: HB 504 relating to TRS pension reform, HB 505, which includes level dollar funding for TRS, and HB 525, proposing to change the TRS board composition. On that, Mr. Gross concluded staff's legislative update presentation.

David Eager, Executive Director, KRS, was asked to join staff to answer some questions from the board members.

In response to an earlier question from Representative Graviss regarding HB 358, Mr. Eager stated that KRS is internally analyzing whether it could garnish funds that might otherwise go to agencies from the state through the general fund. Mr. Eager stated it was his belief that KRS can intercept those funds. Mr. Eager also stated that universities continue to outsource positions and reduce their contribution rates, but the liability for KRS does not go down and is also absorbed.

Representative Graviss stated that there were still outstanding questions regarding HB 358, particularly relating to the inviolable contract issues for employees that are questionable if an entity opts out. Later during the meeting, Mr. Gross explained the history of the original cessation statute, 2015 RS HB 62, and that the systems opined that it did not violate the contract. However, an agency interpretation of legislation does not prevent a party from pursuing litigation.

At the request of Representative Graviss, Mr. Eager said that KRS could provide more specific data regarding the employees that could be impacted by HB 358. He also advised that there is about a $3 billion liability from quasi-governmental entities opting out with roughly one-third of it being for universities, one-third for public health, and one-third for mental health.

In response to follow up question from Representative Graviss, Mr. Eager stated that the actuarial analysis on cash flow assumes that every agency would opt out. Under the lump sum option, KRS would receive a substantial amount of money in the third year. Under the installment option, there is no cost flow projection at this time.

In response to a question from Senator Higdon concerning a quasi-governmental entity opting out of the current system (Tier 1 & Tier 2), he asked if it would be an advantage to KRS if the entity created a new retirement system in Tier 3. Mr. Eager stated he was not sure of the legal aspect, but that there has been discussion that the entity could work with the deferred compensation system to set up plans.

Mr. Eager commented on other aspects of the bill, including that the installment payments that are driven by a contribution rate based on the 2019/2020 valuation will be harmful to KRS; that the actuaries suggest that there are agencies that will never pay the full actuarial cost over installments with no specific end period; and that with at 13 percent funded level, KRS should not be the bank for the unsecured installment loans.

In response to a question from Representative Graviss, Mr. Eager stated that KRS' position has not changed that KRS is financially neutral other than the $121 million for the one year delay. The perception is that the universities are in a more stable position with the ability to raise revenue through tuition and other sources.

**Biennial Investment Review**

Bo Cracraft, LRC Staff, provided a semi-annual investment review. He started with asset allocation, generally, and explained, that how a plan chooses its investments, drives 90 percent of returns. Mr. Cracraft gave a brief description of the traditional and alternative asset classes with the average peer percentages. He then reviewed the market performance of the components of those asset classes and did a comparison between 2017 versus 2018. Next, he provided a review of the current allocations of the systems' asset classes detailing the percentages under each asset class for each of the systems. He noted that public equity returns were low and private equity returns were the strongest performing asset class.

Mr. Cracraft discussed investments for each of the pension plans for the fiscal year to date, 1-, 3-, 5-, 10-, and 20-year rate of return percentages. He also compared the plans' performance to the peer groups' median returns for the 1-, 3-, 5-, and 10-year snapshots.

Mr. Cracraft cautioned that it is difficult to grade performance within a single time snapshot. As an example, Mr. Cracraft discussed specific performance as compared with a one month difference. He stated that December 2018 was one of the worst Decembers on record. On December 24, 2018, the S&P 500 fell by almost 3 percent, and it has never fallen more than 1 percent on that particular day. He stated that January 2019 performance came back strong and was up approximately 8 percent. Mr. Cracraft provided a chart that shows changes from one month to the next for the systems. He explained this is why the actuarial and valuation professionals smooth the returns to obtain a more accurate performance review.

In response to a question from Representative DuPlessis, Mr. Cracraft stated he was not aware of any studies regarding whether the Kentucky systems could benefit by investing in the state park systems, such as how the teachers' retirement in Alabama built and developed the Robert Trent Jones golf courses both within and out of the state. He noted that Alabama is an outlier with these investments and even had ownership of an airline at one time.

In response to a question from Representative Graviss, Mr. Cracraft stated that he had not personally run the numbers at 5.50, 5.75, and 6 percent for KERS nonhazardous, but that this information could be found in the sensitivity analyses conducted as part of the actuarial valuations for both TRS and KRS. He noted that comparing assumptions at this level require the analysis of an actuary.

Mr. Cracraft continued with his presentation showing recent changes with asset allocation for all systems. He stated that TRS did sell equity assets during the third quarter.

Under investment return assumptions, Mr. Cracraft stated that NASRA conducts an annual survey that shows change in median and average public pension plan investment return assumptions. The updated chart shows that the median has now dropped to 7.25 percent.

In response to a question from Representative DuPlessis, Mr. Cracraft stated that if the Federal Reserve raises interest rates, the investment market returns should also rise, but on the flip side there will be an impact as a result of inflation growth. With no additional questions, he concluded his presentation.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, April 22, 2019.