PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 4th Meeting of the 2019 Interim

May 20, 2019

Call to Order and Roll Call

The 4th meeting of the Public Pension Oversight Board was held on Monday, May 20, 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 Gerald A. Neal, Dennis Parrett, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, and Buddy Wheatley; J. Michael Brown, John Chilton, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Other Legislators Attending: Representative Derrick Graham.

Guests: David Eager, Executive Director, Kentucky Retirement Systems.

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

Approval of Minutes

Representative DuPlessis moved that the minutes of the April 22, 2019 meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

Alternative Methods for Prorating Employer Liabilities and Contributions

David Eager, Kentucky Retirement Systems (KRS), started his presentation by discussing the components of the pension contribution. He stated that normal cost is simply the cost to run a system annually if there were no unfunded liabilities, while the unfunded liability cost is the yearly cost to pay down any existing unfunded liabilities. Mr. Eager discussed three ways to calculate a normal cost, including traditional unit credit, projected unit credit, and entry age normal cost. He noted that KRS utilizes the entry age normal cost method, which is the most popular method and used by about 75 percent of public funds. Mr. Eager showed a chart of the three normal cost methods as a percent of annual pay, noting that entry age normal cost method was the most conservative and required more dollars earlier than the other two methods.

Mr. Eager reviewed current contribution rates from the June 30, 2018 valuation for the Kentucky Employees Retirement System (KERS) nonhazardous plan. The blended normal cost of all benefit tiers for both pension and insurance is 10.46 percent, while the total unfunded liability cost for pension and insurance is 74.73 percent. Next, Mr. Eager provided the normal cost for each benefit tier, pointing out that costs had dropped with each benefit reform. He detailed the combined normal cost by tier as follows: Tier 1 (before 07/03) is 13.54 percent; Tier 1 (after 07/03) is 11.57 percent; Tier 2 is 6.75 percent; and Tier 3 is 3.05 percent.

Next, Mr. Eager addressed the two methods of allocating the unfunded liability and the pros and cons of each method. The primary method, which KRS currently utilizes, is to determine each employer's share of the plan's total payroll and allocate the liability accordingly as a percent of payroll. He noted that this method is simple, every employer pays the same rate, and it is the current method, so no change is required. As for drawbacks, Mr. Eager stated this method does not reflect each employer's real liability, will inherently favor employers who have reduced the payroll or have more retirees, and penalizes faster growing employers who do not have a lot of retirees. With regards to KERS specifically, Mr. Eager stated that the quasi-governmental employers represented about 25 percent of the total payroll, but only 20 percent of the total liability, so utilizing the payroll method did result in those employers paying slightly more under this approach.

In response to a question from Representative DuPlessis, Mr. Eager confirmed that when looking at an employer's percentage of payroll, it is based on aggregate dollars relative to the plan's total payroll.

In response to a question from Representative Graviss, Mr. Eager stated that since quasi-governmental employers represent 25 percent of the total payroll, they are paying 25 percent of the unfunded liability costs; however, they only represent 20 percent of the actual liability.

Senator Higdon pointed out that the method of determining contribution rates are currently outlined by statute and the same for all employers participating in KERS.

Mr. Eager continued the discussion and introduced an alternative method for allocating the unfunded liability. The alternative method would determine an employer's share of the plan's total liability and allocate the liability accordingly. Mr. Eager noted this method is more equitable overall, it does not reward employers who reduce payroll, and it does not change long-term costs, except through future experience. The cons to this method are that there will be definite winners and losers compared to the current approach, and the method of calculating an employer's portion of the total liability is less transparent than calculating their share of total payroll.

In response to a question from Representative Miller, Mr. Eager stated that there are one or two universities that are substantially overpaying and most are overpaying to some degree.

In response to a question from Senator Neal, Mr. Eager stated that using the portion of the liability method, the employer's percentage of the total liability remains the same. As the total liability declines, the employer continues to pay the same percentage but the calculated amount will reduce accordingly.

In response to a question from Mr. Harmon regarding quasi-governmental employers paying a reduced rate in comparison to other governmental agencies, Mr. Eager discussed how quasi-governmental employers may be overpaying relative to their actual liabilities but that the reduced rate they are currently paying is significantly lower than what other KERS employers are paying.

Next, Mr. Eager began to discuss how plans amortize the unfunded liability and what considerations have to be made. First, he started with the decision to have an open or closed amortization period. An open period is always the same amortization and is reset to the same period with each valuation similar to a perpetual mortgage. A closed period operates like a traditional mortgage, with the period reducing year by year until the liability is paid off. Next, Mr. Eager pointed out that some plans will use different amortization methods for different components of contributors to the liability. For instance, a new cost of living adjustment might be amortized over a shorter period than a legacy liability. Lastly, plans can utilize a level dollar or level percent of pay funding calculation to determine the amortization payment for the unfunded liability, which is then added to normal cost.

Senator Higdon commented that in the past, the amortization period had been open or reset quite often, which was a contributor to the growth in unfunded liability. Mr. Eager agreed. Senator Higdon added that using the percentage of payroll method, which was built on a 4 percent payroll growth assumption, also led to contributions over the years that were artificially low. Mr. Eager agreed and stated that the change from level percent of payroll to level dollar was by far the largest factor in the increased contribution rates.

Mr. Eager continued the discussion on the current practice of allocating cost on a percent of payroll method and provided an example of why it was not as effective for KERS. He stated the method works well for plans that have a growing workforce, payroll, and modest unfunded liability. However, it does not work as well when payroll is declining, the work force is being reduced, and a plan has a significant unfunded liability such as the KERS nonhazardous plan. As experienced in the KERS fund, these declines have resulted in higher contribution requirements, and those higher contributions have led employers to seek a variety of methods to avoid paying their annual cost, such as, outsourcing, not replacing departing workers, and not reporting workers to KERS. Mr. Eager described this process as a death spiral, where employers cut workforce as the contribution rates continue

to climb, yet the unfunded liability amount remains about the same. Mr. Eager referenced the declining membership in KERS, where over the last 10 years membership had declined by about 10,700 members.

Mr. Eager then reviewed several fixed dollar examples and scenarios that demonstrated a payroll based contribution versus a fixed allocation based contribution, including for universities and other quasi-governmental employers. For each scenario, Mr. Eager noted that under the fixed allocation method, based on the employer's actual liability, the portion or percent of the share of the unfunded liability did not change regardless of payroll growth or actuarial losses.

In response to a question from Representative DuPlessis regarding employers being bought out or filing bankruptcy, such as Seven Counties/Centerstone, Mr. Eager stated, if employers merge or are bought out, he would expect the liability would go with the purchase. However, in the case of Seven Counties, where the employer filed bankruptcy, KERS is still waiting on the courts to determine what happens with that unfunded liability. In any case, under a shared employer plan, Mr. Eager stated that any unfunded liability left by an employer leaving the plan or walking away would be absorbed by the remaining unfunded liability to be paid by the other participating employers.

In response to a question from Representative Wheatley, Mr. Eager stated that the recommendations being made are for all KRS plans, including the County Employees Retirement System (CERS) plans. He could not speak specifically to how underlying employer groups would be impacted in those plans, but stated that the same inequities shown in the KERS plan likely exist.

Mr. Eager concluded his presentation with a review of dedicated funding practices that had been introduced across other states. He noted that staff had been asked for a position on several measures, such as casino taxes, in the past. While KERS does not take a position on any single measure, they would be in favor of any measure that creates dedicated or additional sources of funding. He pointed out some examples, including Arizona - tax on fire insurance policies funds firefighters pension fund; Jacksonville, Florida – 5 percent sales tax for pension fund; Hawaii – constitutional amendment committing state surplus to the pensions; and Kansas – gaming revenues and 80 percent of proceeds from sale of state surplus real estate directed to KPERS until 80 percent funded.

Senator Higdon commented that he believes Kentucky's surplus property should be considered as a revenue source and possibly have legislation passed to transfer it to the pension fund.

In response to a question from Representative DuPlessis, Mr. Eager confirmed that, in aggregate, using the fixed allocation method would result in approximately 48 million less for the group of quasi-governmental employers. However, he stated that there could

still be some winners and losers within the group of quasis, and much of those results would depend on the demographics of their employees and how long they had been in the system. Mr. Eager indicated that KRS staff could provide additional detail on the individual employer impacts.

In response to a question from Representative Graviss with regards to the impact of a fixed dollar allocation on health departments, Mr. Eager stated there was little difference in cost when you consider the group of health departments.

Senator Higdon referenced some information in the members' folders regarding fees for actuarial analyses from GRS Consulting (GRS). Mr. Eager explained that a question had been asked in a previous meeting regarding how much the actuarial analyses cost and how many are conducted. He stated that in February and March 2019, the cost for preparing seven actuarial analyses was approximately $130,000. He explained the process by which requests are reviewed by KRS staff and forwarded to the actuary, and also noted that all fees are paid by KRS as an administrative expense. Mr. Eager mentioned a couple of recommendations from GRS, such as creating controls within LRC to limit the number of analyses requested and/or creating a process under which KRS' actuary could perform a less comprehensive analysis before LRC requests a formal analysis for a bill that has been introduced.

In response to a question from Representative Graviss, Mr. Eager stated that staff are trying to incorporate some internal modeling and base analyses that would save KRS money, if it were able to conduct their own analysis with GRS having a final review.

In response to a follow up question from Representative Graviss with regards to the impact of quasi-governmental employers exiting the system, Mr. Eager stated that under a provision similar to HB 358 or the Governor's proposal, the state's portion would improve slightly given the employers exiting the plan would be paying to exit at a discount rate below the assumed 5.25 percent.

Representative DuPlessis referenced the Governor's proposal and stated that he believed universities wanted the Governor's plan to pass so they could pay to exit. He noted that an infusion of cash from the universities would pay for the total liability of both active and retired members in the system. Mr. Eager agreed with the statement.

In response to a follow up question from Senator Higdon with regards to the proposed legislation allowing universities to exit, Mr. Eager stated the primary driver of any change in unfunded liability from the proposal was the result of a change in the discount rate from current statute. Current law requires the use of a 3 percent discount rate, while the proposed legislation utilizes a 4.5 percent rate.

Mr. Chilton commented on the presentation and pointed out that Mr. Eager had correctly illustrated how the various quasi-governmental employer groups in aggregate were subsidizing some of the state's unfunded liability. However, he noted that within each group, individual employers are also likely subsidizing other employers and referenced the Governor's plan as an option that provides a path and does not require an employer to do anything. Organizations can choose where they would want to go in the future.

Representative Graviss introduced an alternative funding policy and provided members with projections that had been provided on the plan by GRS. Under this proposal, employer contributions would be frozen for both quasi and non-quasi employers at the current 49 and 83 percent rates, while the investment return and payroll growth assumptions would be slightly increased to 6.00 percent and 1.0 percent, respectively. Representative Graviss pointed out that under this scenario, the KERS plan would continue to have cash flow, allow universities to remain in the plan, and protect the inviolable contract. He referenced the projections provided by GRS, which indicated the plan would reach full funding one year later than the current plan.

In response, Mr. Eager stated that changing assumptions would not change what is ultimately required to be paid. He also reminded members that the current statute provides that assumptions are set by the KRS Board. He stated the KRS board had met in March to review a five-year experience study conducted by GRS. As a result of the study, GRS had recommended increasing life expectancy tables, reducing member turnover, and keeping current return and payroll growth assumptions. Mr. Eager stated the board had adopted all recommendations from the study, and he did not believe the board would want to change the assumptions.

Representative Miller commented that CERS was approximately 55 percent funded, compared to 13 percent for KERS nonhazardous, which is why the board approved the higher 6.25 percent return assumption.

In response to a question from Representative Wheatley, Representative Graviss confirmed that under his alternative plan the quasi-governmental employer rate would remain frozen at 49 percent through the 24-year period.

In response to a question from Representative Wheatley, Mr. Eager confirmed that the KRS Board reduced the investment assumption from 6.75 percent to 5.25 percent and the recent recommendation was to stay at the 5.25 percent for the KERS nonhazardous pension fund. Mr. Eager agreed that plans should make smaller incremental changes to assumptions, but in the case of KERS, the plan waited too long. Senator Higdon commented that the proof that the board was correct in changing the assumption is the resulting positive cash flow that is occurring for the first time in years.

In response to a question from Representative Wheatley with regards to the average return assumption across the industry, Mr. Eager stated that the average system is 72 percent funded, while KERS is only 12.9 percent funded, so the plan just cannot invest in some of the less liquid investments like other systems.

Representative Graviss commented that the assumption changes made were extreme in his opinion and that there are quasi-governmental employers who have said they will not be able to survive if a significant increase in the contribution is required. He expressed a need to keep quasi-entities at 49 percent and stated it was a more effective solution that having the state absorb the entire cost of providing those services.

Senator Neal expressed a belief that the alternative plan Representative Graviss introduced should be reviewed further by the Public Pension Oversight Board as a possible alternative option.

Senator Higdon responded that he, as the chair, had allowed Representative Graviss to introduce his proposal.

Representative Graviss commented that the analysis he presented was from GRS, and he stated he is willing to speak with the Co-Chairs regarding the matter. Senator Higdon stated that he had received Representative Graviss' request after the Agenda was set, but still allowed him to present to the committee.

Representative DuPlessis commented that even though the Agenda was set, the Co-Chairs still allowed Representative Graviss to present to the committee. He also commented to Senator Neal that the discussion today was merely an introduction for an alternative plan and that future consideration of all options will be had.

Mr. Eager commented that his topic regarding fixed allocation funding is not affected by any adoption of an alternative plan.

Mr. Chilton stated that he would like to meet with Representative Graviss regarding his proposed plan. Also, the Governor's proposed bill request does not require anyone to do anything. It lays out a path and is based on a principle that employers should pay for their employees' retirement.

With no further business, the meeting was adjourned.