PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 4th Meeting
of the 2021 Interim

June 24, 2021

Call to Order and Roll Call

The 4th meeting of the Public Pension Oversight Board was held on Thursday, June 24, 2021, 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 Christian McDaniel, Robby Mills, Gerald A. Neal, Dennis Parrett, and Mike Wilson; Representatives Derrick Graham, Jerry T. Miller, Jason Petrie, James Tipton, Russell Webber, and Buddy Wheatley; Joseph Fawns, Mike Harmon, John Hicks, and Sharon Mattingly.

Guests: Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System.

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

Approval of Minutes

Senator Parrett moved that the minutes of the May 24, 2021, meeting be approved. Senator Wilson seconded the motion, and the minutes were approved without objection.

Senator Higdon commented that, while watching the Teachers' Retirement System (TRS) board meeting, he noted a couple of items of good news, including a very positive return on investments and the results of the experience study which estimated that the additional funds necessary to fully fund the system would be closer to $300 million rather than $500 million. It was mentioned in the meeting that the additional monies would not be a heavy lift on the General Assembly. However, Senator Higdon disagreed, commenting that, anytime additional money is requested from the General Assembly, it is a heavy lift, especially when there is the additional $300 million on top of the already estimated $629 million to be requested by TRS for next year. The Public Pension Oversight Board (PPOB) will consider, under KRS 7A.250, hiring an auditing firm to audit all of the state-administrated retirement systems to evaluate the reliability of each system's actuarial assumptions and methods.

2021 Actuarial Experience Study Update – Teachers' Retirement System

Beau Barnes, TRS, began his presentation by explaining that an experience study is a common practice performed on a periodic basis by actuaries in evaluating assumptions that have been projected for a retirement system. TRS's experience study covers the five years ending June 30, 2020. The study is a valuable tool, but the process and models used are predictive in nature and forward-looking, with no guarantee that the actual results will match assumptions. There is also an annual valuation conducted by the actuaries to compare their projections to actual experience (gains/loss analysis) and, based on the results, TRS may make adjustments, including changes to assumptions, every year, if necessary.

Mr. Barnes noted that this particular experience study is a somewhat unique. The current fiscal year (2021) has not yet concluded, and having already completed the study means there is some information that is not yet included, such as the current valuation for 2021, which should be reported in November. Based on the FY 2020 valuation, TRS can report that its budget request for FY 2023 will be $629 million in additional funding. The budget impact of the new assumptions will not occur until FY 2024, and TRS will report to the PPOB after the close of the fiscal year as soon as those valuation numbers are available.

Other unusual aspects to this years' experience study are a high investment return in the first 9 months of FY 2021, resulting in over $4 billion in additional assets, and the landmark legislation (HB 258) that created a new tier of benefits for new hires beginning in 2022. Neither of these events are included in the study projections, but they will most certainly will have an impact. In relation to the exceptional investment return, the actuaries noted a trend in other states to phase-in changes to assumptions, particularly the return on investment (discount) rate assumption. The proposal of a phased-in approach using the one-time gain in assets is being studied and will be considered by the TRS board at its next regular meeting in September.

In response to questions from Senator Wilson, Mr. Barnes stated that the statutory 13.105 percent of payroll results in almost $500 million a year in base funding to which the $629 million additional ARC request is added. Mr. Barnes confirmed that it takes roughly $1.12 billion to fully fund TRS, and that this experience study did not take into account the new tier created by HB 258, which passed during the 2021 Regular Session.

In response to a question from Senator Higdon, Mr. Barnes stated that the green box dollars are in addition to the $629 million requested. In response to a follow-up question regarding additional supplemental costs besides the green box dollars, normal cost, and ARC, Mr. Barnes states that there have been payments towards the health insurance trust as well, but believes that the $629 million also includes the supplemental cost requirements. Senator Higdon requested that TRS provide the PPOB with information regarding the supplemental costs.

Mr. Barnes discussed the summary of changes that include lowering the investment return assumption for all plans to 7.1 percent from 7.5 percent on the pension side, lowering the payroll growth assumption to 2.75 percent from 3.5 percent, and updating to new teacher-specific mortality tables.

In response to a question from Representative Miller, Mr. Barnes stated that in the summary of changes, the investment return and payroll growth assumptions are economic assumptions and the mortality tables update is a demographic factor.

In response to a question from Senator Higdon, Mr. Barnes stated that the payroll growth assumption of 2.75 percent is a long-term assumption and 2.50 percent of the assumption is due to inflation.

Mr. Barnes discussed the investment return assumption as compared to a study of TRS's peer systems. A survey conducted by the National Association of State Retirement Administrators regarding assumed investment returns demonstrated that 37 peer returns are at 7 percent and 36 peer returns are 7 to 7.5 percent. With an investment return assumption set at 7.1 percent, TRS views this as a conservative measure compared to peers.

Mr. Barnes discussed the summary of changes for the retirement annuity trust. The total liabilities as of June 30, 2020, were $35.58 billion. The study calculated the dollar impact of the assumption changes, including the totals for member withdrawals, service retirements, mortality tables, salary changes, sick leave, and lowering discount factor to 7.1 percent, for a combined net change in liabilities of $2.95 billion.

In response to questions from Senator Mills regarding mortality tables, Mr. Barnes stated that the new mortality tables resulted in an increase in liabilities by $1.49 billion, with the new tables being teacher specific rather than general population specific. Using the general population gave lower liabilities because the general population does not live as long as teachers. The TRS board did not consider using the general population for the mortality table.

In response to questions from Representative DuPlessis regarding the $120 million in increased liabilities due to sick leave, Mr. Barnes stated that the actuaries found that teachers who are retiring with sick leave tend to be the higher paid members and, therefore, require higher payouts for retirement calculation purposes. Anecdotally, superintendents and other administrators report that they do advise their teachers about the value of sick leave being used for retirement calculation purposes and do so to discourage absenteeism in the classroom.

In response to questions from Representative Miller, Mr. Barnes stated the board has always adopted the reasonable recommendations presented by the actuaries. Furthermore, the board hires an additional independent actuary to review and audit those recommendations. In response to a follow-up question, Mr. Barnes stated that the experience study report was available to TRS staff a few days before the board meeting for review. The dollar impact on the ongoing ARC is uncertain due to the fiscal year not being closed out.

In response to a question from Senator Higdon, Mr. Barnes stated that TRS was comfortable with the assumed rate of return number of 7.1 percent both as to the 2.50 percent inflation component and the 4.60 percent real return component.

Mr. Barnes continued his discussion with the summary of changes for the health insurance trust. The total liabilities as of June 30, 2020, were $2.76 billion. The study calculated the dollar impact of the assumption changes, including the totals for member withdrawals, retirements, mortality tables, salary changes, member participation, health care trends, and lowering the discount factor to 7.1 percent, resulting in a liability increase of $350 million.

Mr. Barnes discussed the budget impact based on the annual valuations. The budget request of additional funding for 2023 already has been determined at $629.4 million. The 2024 budget request will be determined based on the 2021 annual valuation.

Mr. Barnes discussed the nominal total rate of return from 2016 to year ending June 30 that included the actuarial value and market value. The average actuarial value is 8 percent and the market value is 7.1 percent. He also discussed the investment gains and net plan assets for fiscal year 2021 to date for the retirement annuity trust and the health insurance trust. TRS experienced a gain of $4.4 billion in the retirement trust and $367.4 million in gains in the health trust.

In response to a question from Senator Higdon, Mr. Barnes stated that the cost of living adjustment (COLA) is included in the unfunded liability.

In response to questions from Representative Tipton, Mr. Barnes stated that the 0.32 percent for administrative expenses is included in the total normal cost, and it adds about $16 million. Sick days used adds approximately 0.5 years of service and will increase the load from 2 to 3 percent for all active liability for the resulting $120 million increase in total liabilities. Regarding the disability retirement, the experience study did not recommend that the benefit be reduced, however, there will be a small additional cost to the system. Lowering the assumed rate of return to 7.1 percent for the health insurance trust will add additional years before the fund will reach 100 percent funding.

Senator Higdon commented that the bonds referenced are monies that the General Assembly borrowed from TRS to pay health insurance costs that totaled about $800 million.

Mr. Hicks explained that, for all the bonds, the last year of debt service is fiscal year 2023.

In response to questions from Representative Petrie, Mr. Barnes stated, for fiscal year 2023, TRS is requesting an additional $629 million over the statutory obligation. The fiscal year 2024 request will not be less than the fiscal year 2023 request, but at this time that specific amount cannot be provided. As to payroll growth, the inflation component is a broad-based national factor, not an inflation factor specific for just Kentucky. The assumptions for the experience study are driven over what is expected to happen over the 30-year period. However, Mr. Barnes stated that the experience study as presented does not include 30-year projections, but TRS will look into providing those projections.

In response to questions from Representative Petrie and Senator Higdon regarding changing benefits which are not protected under the inviolable contract, Mr. Barnes stated that TRS views those decisions as a matter of policy for consideration by the General Assembly. For the unprotected benefits of sick pay, the high 3 salary calculation at age 55, and the use of the factor of 3.0 percent for years of service beyond 30, the maximum cost savings would be about 1.8 percent of pay. In most cases, those benefits are used as a carrot to encourage employees to work longer, thereby contributing to the system for a longer period.

In response to a question from Representative Miller, Mr. Barnes stated he will follow up regarding changing the 5 year period between experience studies to a rolling cycle, where the system studies the economic assumptions every two years, then reviews the demographic assumptions in four years, and then in the alternate two years thereafter.

In response to a question from Representative Wheatley, Mr. Barnes stated other states are addressing assumption changes in a more measured way with a phased-in approach as opposed to all at once. TRS has not practiced this measure in the past, and its adoption would require board action.

In response to a question from Senator Mills regarding benefits outside the inviolable contract, Mr. Barnes stated the benefits existed before he was with TRS and is not sure who advocated for those policies. For example, the sick leave policy is a Department of Education statute and does not fall directly under TRS statutes. The total cost of the sick pay, the high 3 salary, and the factor 3 percent benefits is roughly in the high $60 million annually, maximum savings. Regarding the usefulness of the benefits for the system, the high 3 does keep teachers working longer, the 3.0 percent factor probably has some affect for those working over 30 years, and being able to use sick leave for retirement calculations is valued by superintendents and administrators as a way to decrease absenteeism.

Senator Higdon commented that in 2018 with SB 151 the General Assembly took a bold move and agreed to statutorily require themselves to make the ARC payment every year along with going to level dollar, which committed them to about $400 million additional at the time.

With no further business, the meeting was adjourned.