PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 4th Meeting of the 2022 Interim

May 23, 2022

Call to Order and Roll Call

The fourth meeting of the Public Pension Oversight Board (PPOB) was held on Monday, May 23, 2022, 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. The committee welcomed guests in the audience: Vivianne Clark, a student from Mentor, Ohio, and Candy Massaroni, the newly elected representative for Kentucky House District 50.

Present were:

Members: Senator Jimmy Higdon, Co-Chair; Representative James Tipton, Co-Chair; Senators Robby Mills, Gerald A. Neal, and Dennis Parrett; Representatives Derrick Graham, Jerry T. Miller, Jason Petrie, Russell Webber, and Buddy Wheatley; and Mike Harmon, John Hicks, and Victor Maddox.

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

LRC Staff: Brad Gross, Jennifer Black Hans, and Peggy Sciantarelli.

Approval of Minutes

The minutes of the April 25, 2022, meeting were approved without objection by voice vote (motion by Senator Webber, second by Senator Mills).

Teachers' Retirement System (TRS) Sick Leave Program

Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System, in conjunction with a slide presentation, provided follow-up information regarding previous committee discussion of the TRS sick leave program.

Mr. Barnes said that the 2022-24 biennial budget provided additional funding needed by TRS and marked the eighth consecutive year of near full funding for the TRS pension fund. It provided more than $1.36 billion to meet the actuarially required contribution for annuities. Less than 23 years remain in the amortization period to pay off the legacy unfunded liability. The budget also provided $149 million for the state statutory contribution for under-65 retiree health insurance, based on the "shared responsibility" legislation; an additional $479.2 million to pay off liabilities for certain previously awarded benefits that had been amortized over a 20-year period; and $78 million for sick leave-related annuity liabilities projected to occur from retirements in the next two years. The actual cost for sick leave-related annuity liabilities will depend on the number of retirees with sick leave and the amount of sick leave included in the final average salary.

Mr. Barnes explained that the $479.2 million pays past sick leave amortized payments through FY 2022 and past supplemental cost-of-living adjustments (COLAs). Of that amount, about $380 million retired the "green box" dollars for past amortized sick leave payments; and about $100 million of the $479.2 million retired the other component of the "green box" dollars—old supplemental COLAs. Payoff from the 2022-24 biennial budget lowers the actuarially determined employer contribution (ADEC) by about one percent of pay, or approximately $39 million annually. In future budgets, sick leave will cost about 1.2 percent of payroll, which is part of the ADEC.

Responding to a question from Senator Higdon, Mr. Barnes explained that 2008 was the last year that the supplemental COLA above 1.5 percent was provided, but payments were required as far back as 2003 and 2004. He added that the $479.2 million saved the Commonwealth $230 million in debt service on the amortized payments, which lowers the cost of sick leave going forward by about one percent of payroll, or approximately $39 million per year. Senator Higdon commended Representative Petrie and Senator McDaniel, the Appropriations and Revenue Committee chairs, and members of the budget conference committee for seeing the importance and value of appropriating the $479.2 million to eliminate pension liability.

Responding to Representative Tipton, Mr. Barnes confirmed that the $380 million that retired past amortized sick leave payments was for retirees and does not reflect the value of active teacher sick days.

Mr. Barnes said the two-year budget that TRS submitted last fall included $78 million for active teacher sick leave liability and did not reflect payoff of the "green box" dollars, which resulted in a savings on the sick leave side of about one percent, or $39 million annually. For more immediate budgets, the cost of active teacher sick leave used as salary credit is 1.2 percent of payroll, or about $45 million annually. Without the unfunded liability for active teacher sick leave, the normal cost would be 0.4 percent of payroll. Most of the 1.2 percent is for the unfunded liability.

Pension legislation in 2008 capped sick leave for salary credit purposes at a maximum of 300 days. This would not affect most members of TRS, but some with long careers have not used much of their sick leave. As a result of HB 258, enacted during the 2021 Regular Session, the teacher accrual of sick leave liability for active teachers ends for those becoming members on or after January 1, 2022. There will be a slow downward trend, with eventually no liability for active teacher sick leave.

Regarding other forms of leave being converted to sick leave, Mr. Barnes provided follow-up information and additional details from questions asked during previous meetings. There are 171 school districts, and most school districts provide 10 days of annual leave for year-round employees—some less, some more. The accrual of annual leave days is based on certain conditions, including years of service. There are limitations and conditions on the use of annual days. Two districts allow the rollover of unused annual days into sick leave on a limited and conditional basis.

School districts comprise approximately 95 percent of TRS members. Only school districts may voluntarily decide to make a lump-sum payment to allow unused sick leave to be used for retirement calculation purposes. The other 5 percent of TRS employers cannot allow sick leave to be used as salary credit, but they may allow their retiring members to use unused sick leave as service credit—not increasing salary but increasing service at the end of their career.

Teachers do not receive annual leave, since they have a summer break, but most districts grant their employees and teachers 1-3 personal days per year. Most districts also allow unused personal days to roll over into sick leave.

Responding to questions from Representative Tipton, Mr. Barnes confirmed that in future budgets, sick leave for current teachers and current retirees will cost about $45 million, or about 1.2 percent of payroll. The cost will go up slightly in the immediate budget due to payroll growth, which is assumed to be 2.75 percent, but in years forward will start to decrease. Universities comprise the largest group of TRS employers other than school districts. The Kentucky Department of Education is probably the next largest. Some other education-related groups also participate in TRS.

Responding to Senator Mills, Mr. Barnes said that if TRS employers outside the school districts decide to compensate their employees for unused sick leave as service credit, they must pay the full actuarial cost, which is not billed to the state. In the school districts, if personal days are converted to sick leave, they are reported to TRS as sick leave from the district, and the cost would be billed to the state.

When asked by Representative Petrie, Mr. Barnes confirmed that the $39 million per year savings from payment of the "green box" dollars will go toward funding the pension fund and will not be applied to sick leave. Mr. Hicks added to the discussion and helped explain the effect of the $39 million savings on the current and future budgets.

When the issue was raised by Senator Higdon, Mr. Barnes spoke generally about the expected normal and actuarial cost and unfunded liability for TRS sick leave. When Senator Higdon asked about the varying use of annual and personal days for sick leave in the school districts, Mr. Barnes explained that sick leave policy is controlled by legislation. TRS has no role or authority in setting sick leave policy in the schools.

Senator Higdon said he will be sending Mr. Barnes a letter to request that the TRS actuary provide in writing the cost and unfunded liability for sick leave going forward, so that the legislature will know how much TRS is expected to request each year. He believes the General Assembly needs to promote understanding of the pension system. One cause of the current unfunded liability is that past actions were sometimes based on a lack of understanding of the unfunded liability and how to properly ensure funding of the pension systems. Senator Higdon said he would appreciate receiving the information from Mr. Barnes at the next meeting of the committee, if possible.

When asked by Senator Mills, Mr. Barnes confirmed that the $78 million that was budgeted for sick leave-related liabilities will go toward total liabilities of the system, now that the "green box" dollars have been paid off.

There were no further questions, and Senator Higdon thanked Mr. Barnes for his testimony.

Overview of Retiree Health Benefits and Funding

Brad Gross, PPOB committee staff administrator, gave an overview of retiree health benefits and funding for public employees. A slide presentation accompanied his testimony.

Mr. Gross said that retiree health benefits for public employees, often referred to in the broader class of "other post-employment benefits" (OPEB), varies among the states and also in Kentucky. Standards issued in 2004-2006 by the Governmental Accounting Standards Board (GASB) have now been replaced by newer standards. Funding standards previously were the same as GASB standards but are now separate from the new GASB standards.

Most states fund retiree health care on a "pay as you go" basis, which means enough money is set aside in a year to pay for that year's benefits. Kentucky is now on a true actuarially prefunded status and is viewed as a solid performer for funding retiree health care.

Most states provide retiree health benefits under three common broad plan designs: percent of premium; fixed dollar subsidy; and implied subsidy. Kentucky employs all three designs, but they vary by system and by tier within the systems. The percent-of-premium design is impacted by medical inflation, which is one reason for changes that were made in 2003 and 2004 to the systems administered by the Kentucky Public Pensions Authority (KPPA). In most states, there are few legal protections relating to retiree health care. Kentucky offers varied legal protections, with most of retiree health care built within a statutory scheme. The administration and funding of retiree health care in most states is separate from their retirement systems; in Kentucky it is included in the retirement systems.

Mr. Gross referred to information contained in the meeting materials. A document from the National Association of State Retirement Administrators (NASRA) gives detailed information on OPEB plan designs for each state. A 2020 NCSL Legisbrief notes that nationwide, only about seven percent of retiree health care obligations were funded with assets, with wide variation among the states. Information from the Center for State & Local Government Excellence provides a 2017 snapshot of OPEB unfunded assets and liabilities, by state. Kentucky, reported as having $5.9 billion assets in 2017, is listed in the top five states having over $1 billion in assets. That number is improving for Kentucky; at the end of FY 2021, assets are closer to $9.5 billion. In 2017, Kentucky's unfunded liabilities are shown to have been $1,411 per capita.

In 2021, Kentucky had unfunded liabilities of $3.2 billion for retiree health. From 2019 to 2020, retiree health unfunded liabilities reduced $1.3 billion; from 2020 to 2021, they reduced $0.3 billion. Factors for improvement include reform packages that were put in place in 2003, 2004, and 2008 for the KERS, CERS and SPRS systems. The transition of those systems from percentage-of-premium to fixed-dollar plans has also reduced cost over time. The TRS retiree health fund has rapidly improved over the last couple of years due to the 2010 "shared solution" provisions. The TRS asset fund has improved, with the statutory rate being above the actuarially determined contribution. Kentucky's health plans have had positive actuarial experience. Medicare-eligible premiums across the plans have remained fairly flat, due in large part to the Medicare Modernization Act, which subsidizes prescription drug coverage for the Medicare-eligible population. The retirement systems have also done a good job finding ways to keep costs down. All Kentucky OPEB plans are now on an actuarially prefunded model.

Mr. Gross provided actuarial data for all of the retiree health plans. The 2021 valuation shows that retiree health for the KERS-hazardous, JRP, and LRP systems is funded above 100 percent—136 percent, 273 percent, and 363 percent, respectively. The 2025 projected valuation shows that funding levels are continuing to improve for all the funds. Full funding is projected in 2049 for KERS-nonhazardous, SPRS, CERS-nonhazardous, and CERS-hazardous. TRS is projected to reach full funding in 2026.

Benefit coverage for non-Medicare eligible retirees, state employees, and school employees is provided by the Kentucky Employees Health Plan (KEHP). Each retirement system has its own Medicare-eligible plan that coordinates with Medicare for the delivery of benefits. Premiums for Medicare-eligible retirees have generally not increased. For TRS, the 2004 Medicare-eligible premium decreased from $274 to $211 in 2022.

Mr. Gross discussed statutory subsidies and premium growth for retiree health coverage under KPPA and TRS. He explained how the changes brought about by HB 290 in 2004, addressed the problem of medical inflation on employer costs. He explained how subsidies are funded for KPPA, JFRS, and TRS. KPPA and JFRS premium subsidies are funded through an actuarially determined contribution based upon the plan's annual valuation. As far as employee contributions, tier 2 employees in KPPA contribute one percent of pay, and KPPA and JFRS employees in the tier 3 cash balance plan contribute one percent of pay. Employer contributions differ for each system but have come down over time as the unfunded liability for retiree health has decreased. So, now Kentucky has three plans—KERS-hazardous, JRP, and LRP—where there are no employer contributions for retiree health because they have reached a level where there is a surplus of assets. In the short to mid-term, employer costs are projected to go down for KERS-nonhazardous, CERS, and SPRS.

For TRS, however, there is an actuarially determined contribution, but funding is based upon a fixed statutory contribution. (See pages 8 -10 of the presentation.) Historically, retiree health was funded with a 0.75 percent of pay contribution from the employee and a 0.75 percent of pay contribution from the employer, which provided sufficient funding until around 1998. After several years of redistribution of funding by board action and borrowing by the legislature, the 2010 "shared solution" was negotiated and passed. The statutory rates to fund TRS retiree health were phased in, and today teachers contribute 3.75 percent of pay; local school districts contribute 3 percent of pay; pre-Medicare retirees contribute the equivalent of the Medicare Part B premium; and the state continues to contribute 0.75 percent of pay and also non-Medicare-eligible premium subsidies.

Responding to a question from Representative Tipton, Mr. Gross confirmed that school districts pay their statutory rate of 3 percent toward retiree health insurance from their own budgets and not from any additional budget line item appropriated by the state.

Mr. Gross discussed key actuarial assumptions for the systems. The investment return assumption is 5.25 percent for KERS pension, 6.25 percent for CERS pension, and 6.25 percent for all KPPA health insurance funds. The health insurance investment return assumption for TRS was recently reduced from 8 percent to 7.1 percent. The assumption for JFRS is 6.5 percent for both the pension and health insurance funds. The payroll growth assumption is zero percent for KERS/SPRS, 2 percent for CERS, and 2.75 percent for TRS. JFRS did not have payroll growth built into their dynamic, but via SB 32 (Senator Higdon, 2022 RS), the system transitioned to a more typical funding model, which is more consistent with the other systems and moves to the level-dollar amortization, which has payroll growth of zero percent. KPPA and JFRS have one set of medical inflation assumptions for both non-Medicare and Medicare plans—6.30 percent for KPPA and 6.25 percent for JFRS. The medical inflation assumption for TRS is 7 percent for non-Medicare and 5.125 percent for Medicare. All trend down over time.

Concluding his presentation, Mr. Gross posed key questions that may need to be addressed in the future. What happens when and if additional retiree health funds reach 100+ percent funding? Will there be an increase in assumption volatility in the near future?

How do the Medicare eligible plans differ among the systems, and what can they learn from each other?

Representative Wheatley said he would be interested in meeting with persons involved in the handling of retiree health for individuals eligible for Medicare. He questioned whether something perhaps could be done on a policy level to capitalize on the positive aspects of the different plans. Mr. Gross suggested that those persons might be invited to speak at a PPOB meeting about what has been done successfully and how it was accomplished.

Responding to Senator Higdon, Mr. Gross explained how SB 209 affects the premiums of employees who work additional years in the hazardous systems. Representative Miller commented on the financial impact of SB 209.

There were no additional questions, and the meeting was adjourned at 2:20 p.m.