INTERIM JOINT COMMITTEE ON STATE GOVERNMENT

Minutes of the 1st Meeting of the 2018 Interim

June 27, 2018

Call to Order and Roll Call

The first meeting of the Interim Joint Committee on State Government was held on Wednesday, June 27, 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; Representatives Jerry T. Miller, Co-Chair, and Kenny Imes, Co-Chair; Senators Ralph Alvarado, Denise Harper Angel, Christian McDaniel, Dorsey Ridley, Albert Robinson, and Damon Thayer; Representatives Lynn Bechler, Kevin Bratcher, Tom Burch, McKenzie Cantrell, Will Coursey, Joseph Fischer, Derrick Graham, Mark Hart, Richard Heath, DJ Johnson, Mary Lou Marzian, Reginald Meeks, Phil Moffett, Jason Nemes, Sannie Overly, Rick Rand, Jody Richards, and Tommy Turner.

Guests: William C. "Chris" Biddle and Hiren Desai, Kentucky Public Employees' Deferred Compensation Authority.

LRC Staff: Alisha Miller, Karen Powell, Daniel Carter, Brad Gross, Kevin Devlin, Michael Callan, Bo Cracraft, Jennifer Hans, Roberta Kiser, and Peggy Sciantarelli.

Senator Bowen welcomed two new members of the Committee: Representative McKenzie Cantrell and Representative Mark Hart.

Overview of Kentucky Public Employees' Deferred Compensation Authority (KDC)

Invited guest speakers from KDC were William C. "Chris" Biddle, Executive Director, and Hiren Desai, General Counsel. They provided copies of their PowerPoint presentation.

Mr. Biddle said that KDC is the official supplemental retirement system for employees of the Commonwealth of Kentucky, local governments, public school systems and public universities, and other political subdivisions. KDC is authorized by statute (KRS 18A.230-18A.350) and attached to the Personnel Cabinet for administrative purposes; it is self-funded and receives no General Fund revenue. Fees for the program are capped at $237 annually per account. To incur that amount in fees would require a minimum account balance of approximately $120,000 to $130,000. Otherwise, there are no fees except for managed account service.

KDC is under the direction of a 7-member Board of Trustees and an executive director. The Board meets quarterly. The State Controller, Secretary of the Finance and Administration Cabinet, and the Secretary of the Personnel Cabinet are ex-officio members; four at-large members are appointed by the governor to 4-year terms. KDC has 26 administrative staff. Recordkeeping, marketing, and communications services are provided by Nationwide Retirement Solutions through a bonded contract that was bid and established through the state procurement process.

KDC offers the following defined contribution savings plans: 457(b), 401(k), and IRA. The 457(b) plan has been offered since 1975 to state and public education employees. The 401(k) was started in 1986. All plans are reviewed and approved by the Tax Exempt Governmental Entity Division of the Internal Revenue Service (IRS). As of December 31, 2017, there are approximately 74,644 participants in the plans—36 percent state, 35 percent public education, and 29 percent governmental agencies. Approximately 44,000 participants are actively deferring, with the remainder being retirees. There are 992 participating employers. KDC assets under management totals $2.9 billion. The average participant account balance is $39,000.

Plan participants make their own investment elections from a spectrum of investment options approved by the board. KDC's investment consultant and the investment subcommittee make recommendations on investments to the full board. The investment consultant—currently Callan—is selected through the state procurement process. There are more than 20 investment options. (Mr. Biddle's slide presentation included a chart showing the four-tier investment fund structure and individual investment holdings.)

In 2017, KDC sent $33.3 million to the Teachers' Retirement System, Kentucky Employees Retirement System, and the Judicial Form Retirement System for the purchase of service credits, averaging $2.8 million per month. During the last five years, $118 million was sent. Both the 457(b) and the 401(k) plans offer the following benefit payout options: total or partial lump-sum distribution, installment payments for a fixed period, or fixed dollar payments.

Concluding his presentation, Mr. Biddle said that KDC works in concert with the Personnel Cabinet and other state agencies to utilize shared information and provide message coordination. Continued cooperation with the Personnel Cabinet, Nationwide Retirement Solutions' new Participant Engagement Plan, and the use of webinars will enable KDC to deliver benefits to employees in a more effective and efficient manner.

Mr. Desai said KDC is aggressively partnering with the Department of Education to spread awareness of the program to school districts. KDC is also working to automate the process for transmitting contribution information. He said he has been a plan participant since 1999. The program continues to grow and excel, but he is surprised at how few people know about it.

Representative Miller agreed that deferred compensation is a wonderful program. When he asked about administrative costs, Mr. Biddle said that the assets of $2.9 billion are in trust. KDC's operating budget is approximately $9 million annually; of that amount, about $5 million is paid to Nationwide Retirement Solutions for marketing, communications and recordkeeping services.

Senator Bowen said he felt it was important for the committee to receive information about the deferred compensation program, which is also available to legislators. He thanked Mr. Biddle and Mr. Desai for their presentation.

Public Pension Oversight Board Overview and Update

Senator Bowen, who is also co-chair of the Public Pension Oversight Board (PPOB), said that in today's world PPOB may be the most important of the statutory legislative committees. He invited everyone to attend the monthly meetings.

LRC staff members Brad Gross, Jennifer Hans, and Bo Cracraft, presented an overview and update of PPOB. Mr. Gross, Committee Staff Administrator, reviewed their PowerPoint presentation as follows.

PPOB, created in 2013 by SB 2, is authorized by KRS 7A.200-7A.260 to review, analyze, and provide oversight to the General Assembly on the benefits, administration, investments, funding, laws and administrative regulations, and legislation pertaining to the state-administered systems. Oversight was initially limited to Kentucky Retirement Systems (KRS)—comprised of the Kentucky Employees Retirement System (KERS), County Employees Retirement System (CERS), and State Police Retirement System (SPRS). KERS and CERS include both non-hazardous (NH) and hazardous (H) benefit and contribution structures. In 2015, oversight was extended to the Teachers' Retirement System (TRS) and the Judicial Form Retirement System (JFRS). All of the systems have pension and retiree health funds, and TRS also has a life insurance fund. PPOB has 19 members—12 legislators, three ex officio members (state budget director, Auditor of Public Accounts, and Attorney General's designee), two appointed by the governor, and one each appointed by the Senate President and the Speaker of the House. The four appointed members are required to have 10 years of investment or retirement experience.

As of June 30, 2017, KRS membership totaled 372,522, with the County Employees Retirement System-nonhazardous (CERS-NH) having the largest membership—217,359. Active members are employees who are contributing to the systems; inactive members are former employees with accounts who have not yet retired; and retired members include both retired employees and beneficiaries. KERS-NH and SPRS have more retired members than active members. KRS is the most complex system and has the most benefit tiers. Membership in KRS, TRS, and JFRS totals 549,959. Assets under management by all the systems totaled $36.8 billion as of June 30, 2017. TRS has the greatest amount of pension assets of all the systems. (Slides 3 and 4 provide additional detail.)

Actuarial valuation results for 2017 indicate that KERS-NH had 13.6 percent in pension assets on hand, with a pension unfunded liability of $13.468 billion. Each year all the systems furnish PPOB with actuarial valuation data for their pension and health insurance funds. (Slide 5 provides detailed 2017 funding level percentages and amount of unfunded liability for each of the systems.)

Mr. Gross said that twice yearly Mr. Cracraft performs a statutorily required bi-annual investment review to compare returns/asset allocation of the 50 states, analyze investment fees, and review historical and recent changes to returns/asset allocations. Other reviews by PPOB staff have focused on investment return and payroll growth assumption, transparency trends, investment expense disclosure and trends, funding policy, administrative expense, and a national comparison review of board governance. (Slide 6 provides additional detail regarding 2016 and 2017 reviews and studies and the type of relevant testimony provided at PPOB meetings.) Mr. Gross added that Ms. Hans regularly produces for PPOB members a legislative update on pension related matters. PPOB staff also draft annual reports that include system summaries, study information and testimony, and recommendations. (Today's meeting materials included a copy of the 2017 report, LRC Research Memorandum No. 524.)

SB 2, enacted in 2017, dealt with transparency. It changed the systems' board governance to add gubernatorial appointees with investment experience, subject to Senate confirmation. It established standards for reporting investment return and expense disclosure and required a consistent process for reporting investment fees for each system, asset class, and manager. SB 2 placed the systems under the Model Procurement Code but excepted procurement policy for investment contracts adopted by a board and approved by the Secretary of the Finance and Administration Cabinet. It also required the CFA Institute's Code of Conduct for staff, trustees, and contracted investment advisors, and also required public disclosure of offering documents and contracts.

Staff has been directed to research and review the effectiveness of the 2017 pension transparency reforms instituted under SB 2 and to report their findings to PPOB in order to determine whether additional transparency or accountability measures are needed. At the June 25 PPOB meeting, Ms. Hans reported on the results of questionnaires that were sent to the systems to ascertain whether they are in full or partial compliance with SB 2. The compliance review is ongoing.

Mr. Gross discussed the issue of CERS separation. SB 226 (2017) would have separated CERS from the administration of Kentucky Retirement Systems. That bill did not pass. Section 86 of SB 151 (2018 RS) directed PPOB to establish an advisory committee to study the benefits and drawbacks of separating CERS or restructuring the administration of the systems administered by Kentucky Retirement Systems. A report on this directive is due by December 1, 2019. Subject to LRC approval, an 8-member advisory committee was established for this purpose at the June 25 PPOB meeting. KRS 7A.260 previously authorized PPOB to establish advisory committees.

Mr. Gross gave an overview of legislation that was enacted to address the issue of agencies' ceasing participation in KERS or CERS. As employer rates have increased, agency participation issues have grown. HB 62 (2015) allowed certain agencies in KERS and CERS to voluntarily cease participating in the systems by paying full actuarial costs. HB 351 (2017) established required assumptions for employers exiting the systems, but this increased the cost and removed the installment payment option. In the 2018 regular session, HB 362 would have provided a window for eligible agencies to cease participating in KERS or CERS by paying actuarial costs through installments without interest over 30 years; however, HB 487 was subsequently passed and removed the window passed by HB 362 for agencies ceasing participation. HB 362 also would have allowed additional quasi-state agencies to exit the systems. HB 265 provided one year of employer rate relief to quasi-state agencies in KERS and kept the rate at 49.47 percent of pay for those employers instead of 83.43 percent of pay. This issue will be studied by PPOB in 2018. Kentucky Retirement Systems is working on potential options and will provide that information to PPOB and the General Assembly prior to the 2019 regular session. In 2018, PPOB will also focus on annual investment reviews, quarterly investment and cash flow updates, cash flow review, actuarial valuations and financial data, and the 2018 annual report and recommendations.

Senator Bowen complimented staff for the thoroughness of the presentation. He said that, by and large, the function of PPOB is an exercise in objectivity that is based on the data that it receives. Determining a viable solution for quasi-governmental agencies that want to exit the systems is a major challenge facing the General Assembly, and State Budget Director John Chilton is working on that issue.

Representative Rand asked about the status of funding levels after passage of the pension reform legislation in 2013. Mr. Gross said that that funding levels dropped below the 15 or 16 percent that had been anticipated. This was due partly to experience, but assumption changes also were a factor. The unfunded liabilities are larger in general than anticipated simply because of function changes and plan experience. Mr. Cracraft said that from 2016 to 2017 almost all of the increase in the unfunded liability was due to assumption changes at KRS. Both KERS and CERS plans saw reductions in payroll growth and the assumed rate of return. Mr. Gross added that in the short term, the decision to pay the ARC and the changes in retiree health insurance also had an impact.

When Representative Rand inquired about the status of the health insurance funds, Mr. Gross said that Kentucky is considered a solid performer in funding retiree health insurance. At one time retiree health represented most of the unfunded liability, but over time those liabilities have decreased due to additional funding and changes that were implemented in 2003, 2004, and 2008. Claims experience has been good on both the under-65 plans and the Medicare-eligible plans administered by the retirement systems. There has even been some deflation on the Medicare-eligible side. Today the predominant share of the unfunded liability is on the pension side.

Representative Miller said he participated in a recent National Conference of State Legislatures conference call in which discussion focused on retiree health insurance—the "other post-employment benefit" (OPEB)—an issue on the radar nationally. Kentucky did the right thing to begin prefunding the OPEB faster than many other states.

In response to a question from Representative Rand, Mr. Gross explained that the combined total unfunded liability reported by the retirement systems is $43.8 billion (as shown on slide #5). That number is used for funding purposes and is based on the 2017 actuarial valuation results. He acknowledged that multiple numbers have been reported regarding the unfunded liability—some as high as $60 billion or $80 billion. He said those higher totals are based on different sets of assumptions, and $80 billion would be more in line with the 30-year treasury rate.

Representative Nemes said that recent testimony in federal court by former deputy attorney general Tim Longmeyer relating to bribery in the awarding of state contracts had alluded to the possibility of operating a similar scheme within the state retirement systems. He asked whether there are restrictions in place that would protect the retirement systems and, if not, what type of preventives should be implemented. Mr. Gross said that is a good but difficult question. He said he would be willing to research the issue. He emphasized the need for transparency and disclosure and the importance of continued input and involvement by the PPOB. Senator Bowen said he believes that the recent request by a hedge fund to withdraw from KRS serves as a testament to the effectiveness of the standards that were put in place by SB 2.

Representative Fischer asked about reliability of the underlying assumptions for the 2017 actuarial valuation. Mr. Gross said that the investment return assumption for KERS-NH and SPRS is 5.25 percent. The assumed rate of return for KERS-H, CERS-NH and CERS-H is 6.25 percent; for JFRS it is 6.5 percent. The numbers have to be viewed from both the liability and asset sides and the expected 30-year return. When costs go up, it is because of liability and change in the discount rate. Senator Bowen said that retirement systems' representatives expressed confidence in the reported numbers at the most recent PPOB meeting.

Responding to further questions from Representative Fischer, Mr. Gross said that the pension plans conduct annual valuations. Nationally, experience studies are typically done every 5-10 years. The KRS board decided to adjust the payroll growth assumption for KERS and SPRS from 4 percent to zero percent, which for all intents and purposes would move it to a level-dollar basis. CERS payroll growth was adjusted from 4 percent to 2 percent, and TRS is at 3.5 percent. Senator Bowen stated that it was difficult for TRS to justify 3.5 percent since payroll growth for that system had averaged only 1.84 percent in the last 10 years.

There were no further questions. Senator Bowen said it is important for assumptions to be accurate and that funding should be at the level required by the assumptions. It is also important to ensure that actuaries are doing a good job in providing the information on which the assumptions are based. He thanked staff for the presentation, as did several members of the committee.

Representative Graham urged the committee to attend PPOB meetings and engage as much as possible in the work of that statutory committee. He also spoke about recent incidents when anti-poverty citizen groups were denied access to the Capitol building. He requested that appropriate officials be invited to a future interim meeting to clarify the procedures and mechanisms relating to access by the public. Senator Bowen said that Representative Graham's request will be taken under advisement.

There being no further business, the meeting was adjourned at 2:13 p.m.