MEMORANDUM REPORT

TO: Donna S. Early

FROM: Findley, Inc.

DATE: February 14, 2019

RE: Actuarial Analysis of Proposed Legislation 2019 HB 186
AA Statement 1 of 2

Findley, Inc. was asked to prepare an actuarial analysis in compliance with KRS 6.350 with regard to the recent proposed legislation ("2019 HB 186") that makes changes to the Kentucky Legislators Retirement Plan ("KLRP").

It is our understanding that 2019 HB 186 makes the following change(s) to KLRP:

> **HB 186** creates a new section of KRS 6.145 to 6.237 to allow individuals who become members of the General Assembly on or after August 1, 2019, to make a one-time irrevocable election to not participate in the Legislators Retirement Plan (LRP) for their service to the General Assembly. It allows members of the General Assembly who began contributing to LRP on or after December 31, 2014, but prior to August 1, 2019, to make a one-time irrevocable election by December 31, 2019, to discontinue participation in LRP for their service to the General Assembly. It provides that the former LRP member shall receive a refund of accumulated contributions; and provides that the election to not participate or discontinue participation in LRP will apply to all future service of the General Assembly.

Comments

The proposal allows current and future members of the General Assemble to opt out of participation in the KLRP:

- While the proposed legislation could result in significant reductions in liability in KLRP, such reductions would be the result of voluntary elections by members to forfeit significant current and potential benefits. Without further data to support that elections not in the financial interest of the member would actually be made, it appears **this provision will have no material impact on the liabilities in KLRP.**

In accordance with KRS 6.350(2)(c), we have the following opinion in regards to proposed legislation HB 186:

1. The estimated number of individuals affected is unknown, but would appear to only end up being a limited number.
2. Estimated change in benefit payments – There is potential for increase in the short-term to the extent elections are made to not participate in the system by current members and they receive refund of accumulated contributions. However, we don't anticipate many would make such an election.
3. There is no estimated change to employer contribution rates.
4. There is no estimated change to administrative expenses.

Actuarially Sound

KRS 6.350 requires us to comment on whether the proposed changes would make KLRP actuarially unsound or, if already actuarially unsound, if such changes would make KLRP "more unsound".

A plan that has adopted a reasonable funding method, uses reasonable assumptions and contributes at a rate at or above the recommended contribution rate (based on these reasonable methods and assumptions), could be considered to be actuarially sound. Whether or not the changes reflected in this study are or are not adopted, will not necessarily impact the "actuarial soundness" of KLRP.

In order to ensure KLRP is funded in an "actuarially sound manner", we would recommend:

1. Revise the actuarial funding method to amortize all past unfunded as well as new liabilities over a period not more than 30 years (in accordance with currently applicable Governmental Accounting Standards 67 and 68) and amortize future gains and losses over a period not more than 15 years.
2. Contribute at least the minimum recommended contribution each year.

Deviations from these recommendations could result in an "actuarially unsound" approach to funding KLRP and may eventually result in KLRP becoming insolvent – that is, exhausting assets at which time all future benefits would be made on a pay as you go basis.

Although the Actuarial Standards of Practice 4 "Measuring Pension Obligations" allows for plan liabilities to be calculated under a legally prescribed method, the statement goes on to say,

> "If, in the actuary's professional judgment, such an actuarial cost method or amortization method is significantly inconsistent with the plan accumulating adequate assets to make benefit payments when due, assuming that all actuarial assumptions will be realized and that the plan sponsor or other contributing entity will make contributions when due, the actuary should disclose this."

It is our professional actuarial opinion that the current legally prescribed method which requires contributions of normal cost plus interest on the unfunded liability plus 1% of the unfunded liability (per KRS 21.525) and the assumption of no future COLAs is inconsistent with the plan accumulating adequate assets to make benefit payments when due, assuming all actuarial assumptions are realized.

Professional Qualifications

This report has been prepared under the supervision of Alan C. Pennington. Alan is a member of the American Academy of Actuaries, Fellows of the Society of Actuaries, and a consulting actuary with Findley, Inc. who has met the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions herein. To the best of my knowledge this report has been prepared in accordance with generally accepted actuarial standards, including the overall appropriateness of the analysis, assumptions, and results and conforms to appropriate Standards of Practice as promulgated from time to time by the Actuarial Standards Board, which standards form the basis for the actuarial report. I am not aware of any direct or material indirect financial interest or relationship, including investment management or other services that could create, or appear to create, a conflict of interest that would impair the objectivity of this work.

Alan C. Pennington, F.S.A.

February 14, 2019
Date

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KENTUCKY RETIREMENT SYSTEMS

David L. Eager, Executive Director

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March 7, 2019

Ms. Katie Carney
Office of Fiscal Statement Review
Legislative Research Commission
Capitol Annex, Room 104
Frankfort, KY 40601

RE: House Bill 186 (2019 RS BR 1058)
AA Statement Required by KRS 6.350
AA Statement 2 of 2

Dear Ms. Carney:

House Bill 186 (2019 RS BR 1058) creates a new section of KRS 6.145 to 6.237 to allow individuals who become members of the General Assembly on or after August 1, 2019, to make a one-time irrevocable election to not participate in the Legislators' Retirement Plan (LRP) or the Kentucky Employees Retirement System (KERS) for their service to the General Assembly. The bill also allows members of the General Assembly who began contributing to the Legislators' Retirement Plan or the Kentucky Employees Retirement System on or after December 31, 2014, but prior to August 1, 2019, to make a one-time irrevocable election by December 31, 2019, to discontinue participation in the Legislators' Retirement Plan or the Kentucky Employees Retirement System for their service to the General Assembly and receive a refund of accumulated contributions; provides that the election to not participate or discontinue participation in the Legislators' Retirement Plan or the Kentucky Employees Retirement System applies to all future service of the General Assembly; and amends KRS 6.505, 61.510, and 61.525 to make technical and conforming changes.

Kentucky Retirement Systems staff members have examined House Bill 186 (2019 RS BR 1058). Our analysis only pertains to KERS. We have determined that the bill will not increase or decrease benefits in any of the retirement systems administered by Kentucky Retirement Systems. The bill would not increase the participation in benefits in any of the retirement systems administered by Kentucky Retirement Systems, but would decrease participation if individuals choose to make the election to not participate in KERS.

House Bill 186 (2019 RS BR 1058) could potentially have a detrimental impact on the actuarial liability of the KERS plan. If new legislators choose not to participate there would be no new liability created because they would not earn credit toward a retirement benefit. However, KERS would also not receive the employer contributions that otherwise would have been received: the majority of which are used to pay for the existing unfunded liability. For example, in the KERS Nonhazardous plan, the actuarially recommended combined Pension and Insurance contribution rate for Fiscal Year 2019 is 83.43%, with 74.73% of that total allocated toward the unfunded liability (66.56% for Pension and 8.17% for Insurance). New legislators would be placed in Tier 3. Based on the 2018 Plan Actuarial Valuation, the Employer Normal Cost Rates for this Tier (the "Employer Normal Cost Rate" is the annual employer cost of providing retirement benefits for today's members net of the employee contribution) are 2.50% for Pension and 0.55% for Insurance in the KERS Nonhazardous

plan.[1] Therefore, while the actuarial liability created by adding another member to the KERS Nonhazardous system is 3.05% (2.50% plus 0.55%), the System would lose 74.73% of the member's salary that would have otherwise been paid and allocated toward paying down the unfunded liability for that System.

Members already participating in the KERS plan on or after December 31, 2014, but prior to August 1, 2019, are under Tier 3. Tier 3 members are potentially eligible to receive a refund of both their own contributions and a portion of the contributions made by their employer on their behalf, but must be vested in order to do so. Due to the date range specified in the bill, these Tier 3 members who elect to decline participation by December 31, 2019 would not meet the five-year vesting requirement and would only receive their employee contributions and any earned interest in their refund. The employer contributions paid on their behalf would remain with the Systems.

In addition to the actuarial impact, part (1)(b) beginning on Line 15 of Section 1 of House Bill 186 (2019 RS BR 1058) would potentially violate the Internal Revenue Service (IRS) "cash or deferred arrangement" (CODA) rule, and risk the tax-qualification of the overall KERS plan. IRS rules treat any tax-qualified pension plan that allows an eligible employee to waive participation and instead receive cash as a violation of the CODA rule. That is, if an employee were permitted to "elect out" of KERS coverage, the employee's required contribution (6% of pay for Tier 2 and Tier 3 members) would not be withheld and deposited to the KERS trust (pre-tax) as with all other eligible employees, but would be included and taxed as regular pay, and no employer contribution (83.43%, FY 2019) would be contributed to the KERS trust. The IRS position is that the employee is effectively receiving a 6% pay increase by electing out of KERS coverage, and thus is not permissible. We believe a Private Letter Ruling from the IRS would be required in order to implement this part of the bill.

In accordance with KRS 6.350 (2)(c), Kentucky Retirement Systems certifies the following:

1. According to the Judicial Form Retirement System's website, as of July 1, 2018 there were 22 members of the Legislators Retirement Hybrid Cash Balance Plan (the plan in effect for General Assembly members elected to a term commencing on or after January 1, 2014). Therefore, the estimated number of individuals affected by this bill are 22 active members and any future members of the General Assembly who decide to participate in LRP or KERS, as well as 34 legislators who are also members of KERS elected within the timeframe specified in the bill;

2. There is no estimated change in benefit payments;

3. There is no estimated change to employer costs; and

[1] *Excludes employee contributions and administrative expenses*

4. There is no estimated change to administrative expenses.

We have not requested any further actuarial analysis of House Bill 186 (2019 RS BR 1058) by the Systems' independent actuary. Please let me know if you have any questions regarding our analysis of House Bill 186 (2019 RS BR 1058).

Sincerely,

David L. Eager
Executive Director
Kentucky Retirement Systems