KENTUCKY TEACHERS' RETIREMENT SYSTEM FUNDING WORK GROUP

Notes of Meeting

July 31, 2015

A meeting of the Kentucky Teachers' Retirement System Funding Work Group was held on Friday, July 31, 2015, at 10:00 a.m., in Room 169 of the Capitol Annex, Frankfort, Kentucky.

Present were:

Members: David Karem, Chair; Mike Armstrong; Jason Bailey; Mary Ann Blankenship; Sen. Joe Bowen; Jane Driskell; Rep. Derrick Graham; Gary Harbin; Todd Hollenbach; Mary Lassiter; Timothy Longmeyer; Roger Marcum; Sen. Morgan McGarvey; Brent McKim; Brigitte Blom Ramsey; Dr. Tom Shelton; Sen. Damon Thayer; Dr. Bob Wagoner; and Wayne Young

Also Attending: Rep. Brad Montell (on behalf of Rep. Jeff Hoover); Sen. Jimmy Higdon; Tom Bennett (on behalf of State Auditor Adam Edelen); Brian Sunderland (on behalf of David Adkisson); and Tracy Herman (on behalf of Amanda Ellis)

Guests: William B. "Flick" Fornia, Pension Trustee Advisors; Ed Koebel, Cavanaugh Macdonald Consulting; Ryan Barrow, Office of Financial Management; William Mack, Morgan Stanley; Dennis Farrell, Morgan Stanley; Beau Barnes, KTRS; Robin Morley, Governor's Office for Legislative Services

1. Call to Order: David Karem, Chair, called the meeting to order.

2. Consultant Introduction: Chair Karem introduced Flick Fornia of Pension Trustee Advisors who will serve as consultant to the work group. Fornia provided his background working in pension reform and a summary of how other states and cities have dealt with the issue.

Rep. Brad Montell asked hypothetically if a new plan is possible for new hires that allowed them to participate in Social Security. Fornia said he didn't know how it would be crafted, but "you probably could. But keep in mind Social Security is not really a good deal." He said most states fight to stay out of the federal program. "I don't think Kentucky would be getting their money's worth either," Fornia also said.

Mary Ann Blankenship noted that KTRS retirees are subject to federal rules that prevent retired teachers from collecting a spouse's Social Security benefit and an offset of benefits earned in other employment.

Brent McKim asked whether closing the pension system to new hires might be a bigger drain on assets and the state's General Fund, since the revenues from the newly hired teachers would go

elsewhere. Fornia said he hadn't reviewed the specifics of an earlier report on the matter, but generally agreed.

"Your problems are not going to be solved by those kinds of fixes," Fornia said. "Your problems are fairly big … I think we're trying to find low-hanging fruit. There's not a lot of low hanging fruit left. I would contend there's probably no low-hanging fruit left."

Fornia said other states have responded by increasing contributions "and you really haven't." Unless contributions are increased, the current plan is on the road to insolvency. "You can't just ignore this," he said. The first goal is to avoid getting to a funding level of zero percent and the next goal is getting to 100 percent, so that future generations don't have to pay for the retirements of their predecessors.

In response to Fornia's discussion, which mentioned the inviolable contract, Senate Majority Floor Leader Damon Thayer said he appreciated comments on the role of taxpayers in the funding issue. But, in regard to going forward, "I don't think anybody's talking about breaking contracts. I've not said anything about breaking a contract in Kentucky and I don't think anybody has." Thayer said the issue is whether the state can continue to afford the risk from employees who aren't yet in the system and how that would impact promises made to current retirees and employees.

3. KTRS Actuarial Overview: Chair Karem introduced Ed Koebel, Principal and Consulting Actuary, Cavanaugh Macdonald Consulting.

Koebel presented information about how the annual required contribution is determined based upon factors such as the market value of assets and the amounts of contributions and liabilities.

Rep. Montell questioned the accuracy of how the state's contribution is explained, saying the state also funds an additional amount of about 3 percent for cost-of-living adjustments and sick leave payments. "This is a consistent every year funding," Montell said. "…If we're trying to lay out all the facts we ought to get credit for what we're putting in each year because we've all got skin in the game and so let's make sure it's out there."

Koebel said that the COLA and sick pay payments are not considered actuarially in determining the state contribution.

Koebel said that the continuation of current funding would lead to a reduction in the funding ratio from the current 53.6 percent even if the return on investments met the expected 7.5 percent level. A rate of return of 8.5 percent essentially would keep the same funding ratio through 2032.

Sen. Morgan McGarvey asked what is the likelihood of 7.5 percent returns, and Koebel responded that the 7.5 percent is the actuarial 50th percentile estimate expected over the long term, while individual years can be better or worse.

4. Perspectives on Pension Obligation Bonds: Chair Karem introduced Ryan Barrow, Office of Financial Management; and William Mack and Dennis Farrell, Morgan Stanley.

Mack said pension obligation bonds are neutral to an agency's credit rating when they are used for more than just filling a budgetary gap. Otherwise they are negative, especially if they're used for a holiday from the otherwise required contribution. Mack said that interest rates, while not at all-time lows, remain favorable and should do so through mid-2016.

Farrell discussed the methodology for the different bonding rating agencies. Moody's treats unfunded pension liability as equal to traditional debt.

Barrow said he routinely gets calls from credit analysts inquiring about the pension obligation. In response to a question from Rep. Montell about structural change – beyond just funding – being the factor that neutralizes the impact of new pension bonds on bond ratings, Mack said the plan surrounding the bonds has the positive credit impact for the state, not the bonds themselves. In response to a question from Rep. Montell about the possibility of a $3.3 billion bond adding 30 percent to the state's debt, Barrow said the entire amount wouldn't be issued at once. The bonding would impact the state's credit rating, but the unfunded liability also has an impact because Kentucky's funding is in a worse position than its peers.

McKim noted that structural reform doesn't necessarily mean changing plan design, saying that the most significant improvement would be consistently paying the annual required contribution. He referenced the Jan. 26, 2015 Standard & Poor's analysis of Kentucky's 2013 pension reform efforts. The report said the full funding of the ARC is a positive, but the impact of some measures, such as creating a hybrid cash plan, is unclear.

Mack concluded saying that paying the full contribution to the retirement system is the key; pension obligation bonds work best as part of an overall plan and not as the entirety of the plan.

5. Contractual Benefit Review: Chair Karem introduced Beau Barnes, KTRS.
Barnes outlined the Kentucky inviolable contract and how a task force report issued during Gov. Ernie Fletcher's administration found that the state's language is one of the strongest contract provisions in America. The report reads:

> Its statute expressly states that pension benefit laws constitute an inviolable contract of the Commonwealth and the benefits provided therein shall ... not be subject to reduction or impairment by alteration, amendment, or repeal. Thus under Kentucky law, pension benefits for public employees are a contractual right, and those benefits may not be reduced or terminated by the legislature retrospectively. (See: Blue Ribbon Commission, Public Retirement Systems, Dec. 2007, p. 32.)

Barnes said the following KTRS benefit provisions are not covered by the inviolable contract:

- the specific benefits of retiree health care (the contract guarantees access);
- basing pension amounts on the high-three years for people 55 and older who have 27 years of service;
- post-retirement re-employment, retirement benefits for part-time or substitute teachers;

- sick day payments being included in the pension calculation;
- the 3.0 multiplier for retirees above 30 years of service for those additional years.

In response to a question from McKim, Barnes said he believes the high-three results in a net savings to the teacher pension plan because teachers delay retirement to at least age 55 and, as a result, the retirement system pays benefits to the person for fewer years.

In response to questions from Sen. Thayer about whether teacher retirees can get a second pension, Barnes outlined re-employment rules. Those include:

Unlike KRS, most retirees are limited on how much they can earn when returning to work. Retirees do contribute to a second account, but they rarely vest for a second pension, and, instead, they usually receive a refund of their contributions. This is actuarially beneficial to the retirement system because a retiree seeking a second pension pays the full employee contribution and gets no duplication of survivor benefits, medical insurance, life insurance or disability coverage. The return-to-work rules also help school districts find experienced substitute teachers. A three-month break is required for a retiree returning part-time to the same employer or full-time to a different employer. Someone returning full-time to the same employer must sit out a year.

In response to Sen. Joe Bowen, Barnes said the high-three carrot is an actuarial savings for the pension plan and is important.

In response to Rep. Derrick Graham, Barnes noted many who return to work teach math, science or foreign language.

Chair Karem, noting he is a state Board of Education member, said a real problem exists in the commonwealth finding math and science teachers in some locations. He said the impact of Funding Work Group recommendations on that need "is a really critical piece of this thing."

6. Where Do We Go From Here: Chair Karem recognized Mr. Fornia for closing comments. Fornia reported that absent an increase in contributions, the teachers' pension fund won't be able to pay the current level of benefits and, without any new funding, would run out within 20 years. Based on that, Fornia presented broad alternatives for the Funding Work Group.

- Increase contributions
- Reduce benefits
- Some combination of both

Fornia noted that pension obligation bonds can help, but are a risk and would not solely be a complete solution. A phased-in build-up to the full annual required contribution is the key driver. In striving for that, the question is what benefit changes meet our legal commitments and minimize the impact on Kentucky's education system.

Fornia said he believes that breaking the inviolable contract is eliminated as an option. "I've never heard anyone say they want to do that," he said.

Sen. Jimmy Higdon said one of the first points he believes should be changed for future hires is the use of sick pay in the pension benefit calculation. He clarified that his concern is about that use of sick pay and not about the lump sum payment itself.

Adjournment: The KTRS Funding Work Group adjourned at 1:52 p.m.

Kentucky Teachers' Retirement System Funding Work Group

List of Follow-up Information requested at the meeting on July 31, 2015

1. Rep. Montell requested a cost analysis of changing the sick leave policy.
2. Sen. Bowen requested 30-year funding projections.
3. Rep. Montell said he'd like to know what percentages other states are contributing.
4. Members requested that benefits comparisons to other states be broad based – not just pensions – and also reflect cost of living.
5. Sen. Thayer said the working group needs to know the savings available long term – if there are any – if structural changes are made outside the inviolable contract, including AIR time, re-employment, COLAs, retirement age, employment contribution levels, high three vs. high five, health insurance and sick leave.
6. Rep. Graham asked for a cost analysis for school districts if sick leave is removed from the pension benefit calculation.