KENTUCKY TEACHERS' RETIREMENT SYSTEM FUNDING WORK GROUP
Notes of Meeting
Aug. 28, 2015

A meeting of the Kentucky Teachers' Retirement System Funding Work Group was held on Friday, Aug. 28, 2015, at 10:00 a.m., in Room 149 of the Capitol Annex, Frankfort, Kentucky.

Present were: Members: David Karem, Chair; David Adkisson; Mike Armstrong; Jason Bailey; Mary Ann Blankenship; Sen. Joe Bowen; Jane Driskell; Auditor Adam Edelen; Amanda Ellis; Rep. Derrick Graham; Gary Harbin; Treasurer Todd Hollenbach; Secretary Mary Lassiter; Secretary Timothy Longmeyer; Roger Marcum; Sen. Morgan McGarvey; 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); Kelly Dudley (on behalf of Speaker Greg Stumbo); Mary Ruble (on behalf of Brent McKim); and Ed Ross (on behalf of Secretary Lori Flanery)

Guests: William B. "Flick" Fornia, Pension Trustee Advisors; and Robin Morley, Governor's Office for Legislative Services

1. Call to Order: David Karem, chair, called the third meeting of the Kentucky Teachers' Retirement System Funding Work Group to order and called members' attention to the notes of the previous meeting. Chair Karem then recognized Robin Morley to summarize three communications that the group received on its website.

2. Review of July 31 meeting: Chair Karem recognized consultant Flick Fornia who began by reviewing takeaways from the previous meeting, including the benefits and risks of pension obligation bonds. Gary Harbin noted that the 2015 bond proposal was intended to improve cash flow to avoid the sale of assets to pay teachers' benefits. KTRS sold $650 million in assets in the most recent fiscal year to pay benefits, meaning 37 cents of every dollar paid to teachers in retirement benefits came from asset sales. Over the next four years, $3.5 billion in assets will be sold. "That is a huge risk to us," Harbin said, noting that the agency already has pulled back on its alternative investment strategy. He said the bonds would have been a "bridge loan" for the state to step up to the full funding.

    a. Sen. Joe Bowen asked Harbin whether the "bridge loan" term was used in the House Bill 4 conference committee, saying it was a new term to him. Harbin said he wasn't in the conference committee and didn't know what term was used in those discussions, but the bridge loan was the philosophy from the beginning.

b. Mary Ruble asked whether it's true that any retirement plan that relies in part on investment returns has inherent risk in its portfolio and whether the difference in that risk for a pension and 401(k) is whether the risk is born by the group or the individual. Fornia agreed and added that a pension plan also shifts longevity risk to the group rather than the individual.

3. Benefit and Reform Analysis: Chair Karem again recognized Fornia for a presentation comparing benefits for three hypothetical future teachers under different scenarios in various states.

   a. Fornia outlined the three hypothetical future teachers. The first would be hired at 24 (the median age for the youngest third of new hires), the second would be hired at 33 (the median age for new hires) and the third would be hired at 48 (the median of the oldest third). Their benefits were compared among a series of non-Social Security states (Alaska, California, Colorado, Connecticut, Georgia, Illinois, Louisiana, Maine, Massachusetts, Missouri, Nevada, Ohio, Rhode Island and Texas) and Kentucky's border states (Ohio, Indiana, Illinois, Missouri, Tennessee, West Virginia and Virginia).
   b. Mary Ann Blankenship questioned how the data addressed states where the employer contribution is different among different districts. Fornia acknowledged the issue and said his statistics are a composite for comparing major provisions, such as multipliers, final average pay period, cost of living adjustments and retirement eligibility. It did not address issues such as member contribution rates, non-retirement benefits or sick leave conversion.
   c. The teacher hired at 33 and retiring at 62 showed under KTRS rules would get about 70 percent of pay, among the best of the non-Social Security states studied. "You're fairly strong in this average teacher that works a full career," Fornia said. Secretary Longmeyer questioned whether the data was weighted for pay levels or was strictly based on a percentage of final salary. Fornia said it was strictly final salary and that, for example, Alaska and Hawaii fared better in dollar amounts than in percentages. "The reason that we do it this way is because the purpose of a pension fund is to allow someone to live in retirement," Fornia said. "… The idea is we want to replace the income."
   d. David Adkisson asked whether tax policy, for example exemptions, were factored. Fornia said they were not.
   e. Rep. Brad Montell asked whether the four Social Security state teacher retirement plans took into account Social Security's early retirement provisions. Fornia said the numbers were reduced to reflect the penalty that would be paid for retiring at 62.
   f. The teacher hired at 48 and retiring at 65 under KTRS rules would get just more than 30 percent of pay. Fornia said that he did not include Social

Security credits likely earned by a person prior to becoming a teacher at 48. "For this teacher, you're probably about the middle of the pack," Fornia said, excluding the Social Security states. "That's the way you've designed your plan. You've got these incentives to work longer."

g. Blankenship said she supported Fornia's methodology in not accounting for Social Security earned outside the classroom because the federal anti-windfall law sharply reduces any Social Security payments teachers receive. Fornia, at the request of Chair Karem, then explained the philosophy behind and function of the federal law.

h. The teacher hired at 24 and retiring at 55 under KTRS rules would get 75 percent of pay. "Here, you look very good," Fornia said. The statistics for the Social Security states show an actuarially adjusted benefit for teachers in those states, although no Social Security could actually be drawn at 55. Kentucky's numbers are higher because some states don't allow retirements at 55 or penalize the teachers who do. Based on those numbers, Fornia said the benefit level for teachers retiring at age 55 may be one area where Kentucky could change benefits and reduce cost.

i. Rep. Montell asked whether other states use a certain age for retirement. Fornia said states have various ways of doing that, including requiring an age and a certain number of service years for retirement while others have rules that combine age and service years – for instance, in a rule of 80, a person would need retirement age and service years to add up to 80.

j. Rep. Montell asked whether Kentucky may be one of a few states that would allow a 49 year old to retire after 27 years? "Are we out there sort of with a small group that still does that?" Fornia said yes, with the caveat that many states allow an early retirement with a penalty. "You're one of the very few states" that would allow the younger teacher to retire without a penalty.

k. Responding to a question from Blankenship, Harbin said the average age at retirement in Kentucky is 58 with 30 years of service. Most do retire at 55, but the next most is after 60.

4. Teacher contribution rate: Fornia said the teacher contribution rate is higher in Kentucky than in most states compared. In response to Harbin, Fornia said Kentucky's number includes the medical insurance contribution.

5. Wage comparison: Kentucky is 10 percent below the national average. In response to Chair Karem, Fornia said the salary table doesn't take local cost of living into account.

6. Comparison conclusions: Several states have made significant reductions in teacher pensions for future teachers. KTRS benefits are higher as a percentage of compensation for long-serving, younger future teachers. KTRS benefits are slightly higher as a

percentage of compensation for average future teachers retiring at 62. KTRS benefits are lower than other systems for future teachers hired at later ages. Kentucky teacher compensation is somewhat lower than many states.

7. 2008 Kentucky teacher pension changes: The cuts made in 2008 make the pension plan 1.25 percent cheaper as a percentage of pay for every new teacher compared to what they'd be if hired under the pre-existing system. "That's not insignificant," Fornia said. "That's helping you get back on the track."

8. Case studies of pension reform: Fornia reviewed the states that have changed cost-of-living rules, employee contributions, implemented hybrid plans or shifted risk between the employer and employee. Kentucky has a relatively low COLA and many states that changed COLAs have faced lawsuits.

    a. In response to Adkisson asking if any non-Social Security state had converted to defined contribution or hybrid plans, Fornia cited Alaska and, going forward, Rhode Island.
    b. In response to Sen. Bowen, Fornia said COLA changes may have mattered most in Ohio's reforms, but that all four major changes (COLAs, health care collaboration, later retirement and increased teacher contributions) were "pretty powerful."
    c. In response to Harbin's question about the strength of the inviolable contract in Ohio, Fornia said, "They had more flexibility than you do for sure."
    d. In response to Blankenship, Fornia said Tennessee and Wisconsin made changes without really needing them.
    e. In response to Secretary Mary Lassiter asking about Colorado, Fornia said the COLA change was the most important (though that was an easier change there because the COLA was higher than Kentucky's), but that changes were spread relatively evenly among constituent groups (taxpayers, employees, retirees and future employees). He also said the state increased its contribution in connection with the COLA decrease.
    f. In regard to Rhode Island's changes, Fornia said freezing the benefit particularly hurts mid-career people.
    g. In response to Sen. Bowen saying he didn't see any bonding as a solution in these states, Fornia said Illinois historically bonded, Colorado considered it and Rhode Island has in the past. Since Rhode Island entered reform after bonding, Sen. Bowen asked if it's fair to say all the states studied reformed their pension plans without bonding, and Fornia said, "for the most part, I'd say that's fair." Fornia additionally said bonding can be effective.
    h. In a discussion of the 2015 bonding proposal, Rep. Montell said House Bill 4 had no structural changes, unlike the changes being discussed by the current funding work group. "The conversation is good. We're talking about what types of things can we do

moving forward that will reduce this unfunded liability that we continue to see driving us."

i. Fornia responded that the group should not reject bonding now as an option just because members might not have liked the 2015 legislative proposal.

j. In response to Jason Bailey asking about which states' reforms included funding increases, Fornia said he wasn't sure.

9. Initial review of KTRS actuarial assumptions: Initial impression is that costs and liabilities are being fairly represented. Expected rate of return and mortality basis are typical, but the inflation assumption is higher than the median (which increases higher costs and liabilities). More analysis is coming but Fornia said his initial conclusion is that the problem isn't being overstated.

10. Sources of unfunded liability increase: From 1999-2013, investment returns were almost 45 percent of the source of KTRS's underfunding compared to almost 60 percent nationally. Fornia said two major market corrections occurred in that timeframe and that the numbers would be different if viewed from 1990 onward. Contribution shortfalls represented about 20 percent of Kentucky's problem compared to more than 20 percent nationally. Benefit changes improved the situation slightly nationally while contributing nearly 5 percent of the Kentucky underfunding. Assumption and method changes represented more than 20 percent of Kentucky's unfunded liability, while less than 10 percent nationally. The difference for Kentucky could be that in 1999 the actuary reported Kentucky's at their actual value before the market tanked – while other states nationally smoothed their assets. "I don't see that you were being led astray in 1999," Fornia said, noting what the actuary did was reasonable. In response to Sen. Bowen, Fornia said removing the assumption and method changes bar would increase the other categories proportionately. Fornia confirmed that the information in the chart presents an incomplete picture because the information cuts off at fiscal year 2013 – and adding the following year, where KTRS had a good investment return while the state made no additional contribution, makes the investment bar look better and the contribution bar look worse.

11. Actuarial calculations in process: Fornia reviewed actuarial estimates that are being prepared for the work group, including the impacts of a potential new tier for new hires. Rep. Derrick Graham suggested that the new tier analysis include what the impact would be on attracting teachers and that the educational impact be considered by the General Assembly and the Chamber of Commerce. Chair Karem agreed that the impact needs to be considered, particularly as teachers are asked to do more and have more involved evaluations. Armstrong said another part of the analysis should be the stress that the new teaching tier could place on retirees as the only answer if new teachers become more difficult to attract, something he called a "potentially almost bizarre scenario."

12. Next meeting: The process to speak at the Sept. 11 meeting was outlined, including an expected time limit of five to seven minutes. Member Tom Shelton questioned whether a forum could be scheduled where teachers could address the work group without having to miss class. Secretary Lassiter said the work group members can bring the qualitative concerns of their members to the panel.

13. Adjournment: The meeting adjourned at 1:47 p.m.

Kentucky Teachers' Retirement System Funding Work Group Requests

List of Follow-up Information requested at the meeting on August 28, 2015

- Sen. Bowen and Rep. Montell requested an employer contribution comparison for the various states being studied.
- Secretary Longmeyer requested seeing educational outcomes in other states for recommendations being considered by the work group.
- Secretary Lassiter asked that options for the future being considered have quantitative sensitivity analysis done around them.
- Brigitte Blom Ramsey requested a matrix that lays out policy changes along with the impact on the annual required contribution that each brings.
- Ramsey also questioned whether a national organization could be brought in to present information about qualitative issues that would result from changes.
- Sen. Morgan McGarvey requested the numbers of teachers who retire before 50 and before 55.
- Adkisson requested compensation in the comparisons be adjusted for cost of living to get at the real purchasing power of Kentucky teachers.
- Bailey requested an analysis of what pension benefit changes could mean in terms of the profile of workforce and the cost of education.