KENTUCKY TEACHERS' RETIREMENT SYSTEM FUNDING WORK GROUP

Notes of Meeting Oct. 16, 2015

A meeting of the Kentucky Teachers' Retirement System Funding Work Group was held on Friday, Oct. 16, 2015, at 10:06 a.m., in Room 169 of the Capitol Annex, Frankfort, Ky.

Members present: Chair David Karem; David Adkisson; Mike Armstrong; Jason Bailey; Mary Ann Blankenship; Sen. Joe Bowen; Jane Driskell; Amanda Ellis; Rep. Derrick Graham; Gary Harbin; Treasurer Todd Hollenbach; Roger Marcum; Brent McKim; Sen. Morgan McGarvey; Brigitte Blom Ramsey; Dr. Tom Shelton; Speaker Greg Stumbo; Sen. Damon Thayer; Dr. Robert Wagoner; and Wayne Young

Also Attending: Tom Bennett (on behalf of Auditor Adam Edelen); John Brady (on behalf of Secretary Flanery); Sharron Burton (on behalf of Secretary Dinah Bevington); Rep. Brad Montell (on behalf of Rep. Jeff Hoover); Sen. Jimmy Higdon; and Rep. James Tipton

Guests: William B. "Flick" Fornia of Pension Trustee Advisors; Linda Bournival of KMS Actuaries; and Robin Morley, of the Office of Gov. Steve Beshear

1. Call to Order: David Karem, chair, called the sixth meeting of the Kentucky Teachers' Retirement System Funding Work Group to order. He noted that he requested that copies of the governor's executive order that created the work group and Lt. Gov. Crit Luallen's speech at the first meeting be distributed to members as a reminder of the task. He said he believes the task is addressing the funding problem for KTRS by delivering a vetted series of options to the General Assembly that could be used to address the crisis.

2. Recap Sept. 25 meeting: Flick Fornia was recognized to review his presentation from the prior meeting.

   a. Mary Ann Blankenship asked whether benefit cuts discussed for future teachers, as mentioned last month, would be 3 percent of the benefit received or 3 percent of pay (the latter of which relates to the 14 percent of pay that is the funding shortfall). Fornia said the percentages are of pay.
   b. In response to David Adkisson, Linda Bournival said a slide about a 1 percent possible cut for current members was as an example of an unspecified combination of possible changes outside the Inviolable Contract.
   c. In response to Rep. Brad Montell, Gary Harbin said that the past cost of living adjustments for teachers greater than 1.5 percent and sick leave costs were built into the bonded additional contribution in 2015 House Bill 4.
   d. In response to Brent McKim asking whether the cut discussed for the state's contribution would mean it contributed less to teachers' retirements than what any employer would contribute for any worker through Social Security, Fornia said that's true. After Fornia added that teachers also earn a better benefit than what Social Security recipients receive,

McKim said, "I think teachers ought to be worth, from the employer, at least as much as what any other employer" would provide for a worker's retirement.

e. Jason Bailey asked if a 3 percent of pay cut was a 20 percent cut in benefits. Fornia agreed.
f. Dr. Tom Shelton questioned the assumption that removing the high-three year salary average would result in a savings regarding current members since that change was made to keep teachers teaching longer, resulting in them drawing less actuarially (short of raising their retirement age). Fornia said it would be worthwhile to refigure the analysis, which presently assumes no change in behavior by teachers eligible to retire. He said the saving is probably less than the 0.65 percent of pay currently shown because teachers may retire sooner without the incentive, but he does believe it would be a savings.
g. In response to Blankenship asking for different amounts in each variable that could be cut, Fornia said that the potential savings are so small – just tenths of a percent of pay − that showing a different retirement year or service requirement for all of those variables probably isn't the best use of time as the shortfall is 14 percent of pay. Blankenship said what's politically viable might get down to tenths of a percent of pay.
h. Harbin said the increased cost of retiree health care also must be considered in the cost analysis if benefit cuts lead teachers to retire sooner.
i. In response to Adkisson, Fornia said at most that 1.56 percent of pay could be cut for current teachers and it's probably less when behavioral changes that the cuts would cause are factored.

3. <u>Additional information on broad solution alternatives</u>: Fornia provided additional information on broad solution alternatives and how they may help the state get the 100 percent funding in 30 years.

a. Chamber of Commerce scenarios: In prefacing the Chamber of Commerce requests for possibilities to be examined, Adkisson said they were borne out of the notion of shared responsibility being common sense, and that a shared responsibility approach proved successful in addressing the KTRS health care liability in 2010. In general, the approach to making up the 14 percent of pay to satisfy the unfunded liability would require 50 percent in new money and 50 percent from benefit cuts outside the Inviolable Contract. Fornia said the maximum from current teachers would be 1.5 percent of pay from existing teachers. He didn't see benefits being cut for existing retirees. This chamber request produces some savings, but Fornia said his question would be whether this is too onerous of a decrease in the value of the retirement benefit for teachers.
    1. In response to Blankenship, Harbin said the contribution rate for current active teachers is part of the Inviolable Contract and could not be increased.
    2. Rep. Montell asked whether a 20-percent benefit cut for teachers would equate to an out-of-pocket 20-percent cut since raising the retirement age for future hires accounts

for some of that savings. Fornia agreed, in large part, saying, however, that some teachers would retire early with penalties.

3. In response to Bailey asking for a policy reason why a phase-in would be advantageous since a similar effort for KRS caused problems, Fornia said there is no reason other than budget constraints. “It’s the same reason you’ve been underfunding in the past,” Fornia said.

b. House Bill 4 conference committee alternatives: The conference committee received changes to the current benefit plan that included increasing the retirement age to 62, raising the incentive for the high-three salary average to 30 years, limiting all sick leave payouts to five-year average computation, restricting sick pay so that it could not boost a benefit beyond 100 percent of final pay. The entire menu would reduce normal cost by 0.36 percent of pay.

c. Reducing the discount rate of 7.5 percent: Fornia said it isn’t reasonable to assume that teachers could earn 7.5 percent on their own in the markets.

1. In response to Blankenship, Harbin said KTRS’s investments have resulted in a return of more than 7.5 percent over time – closer to 9 percent over 30 years. Also, Fornia said KTRS indicates that dropping the discount rate by 1 percent would increase the unfunded liability by $3.5 billion.
2. Rep. Montell said he didn’t understand how the current predicament exists when the legislature contributed more than its normal cost, teachers paid their normal cost, investments met the needed return – unless the plan costs more than currently estimated. Fornia said the main reason is because the state never has paid the unfunded liability to get to 100 percent funding. The market almost accomplished that for the state, but, since, the debt has gone higher and higher in the flat-return decade that followed the 90s.
3. Harbin said the plan historically has been underfunded, even from the beginning when a $1.5 million request in1940 resulted in a $1 million appropriation. In 1975, the plan was 25 percent funded. In 1986, it was at 54 percent. The pension system has earned 8.5 percent since 1985, a great return, but earning 8.5 percent on only 54 percent of the assets it should have had doesn’t get you to 100 percent funding. The magic times in the 1990s, when people thought the Dow Jones Industrial Average might hit 30,000, were based on money that only existed in the minds of the market and the market quickly took those away. And then, in 2008, it was zapped again. Markets were flat from 2000 to May 2013. So it wasn’t possible to earn 7.5 percent, but liabilities continued to grow and assets (by way of contributions) didn’t grow at the same rate. Contributions in Kentucky are where they were in 2000, unlike other states that have increased contributions.
4. In response to McKim, Fornia said the median discount rate nationally would be either 7.5 or 7.75 percent. In response to McKim, Harbin said the 10-year return is about 7 percent and is among the best half of returns in the country.

4. Projections: Fornia discussed updates to his model of potential changes and then demonstrated some of the changes that could be made. Among them, the employer funding contribution might only have to increase 6 percent of pay, instead of 8 percent of pay with a $3.3 billion pension obligation bond.

a. In response to Adkisson, Harbin said the bonds would have saved $200 million a year.
b. Blankenship requested running scenarios of bonding at various amounts.
c. In response to Sen. Bowen asking for an example where pension obligation bonds have worked, Fornia said bonds issued in the 1990s worked while some of the ones that failed mentioned by the senator were in financial distress before the bonds were issued. Fornia said the return on bond proceeds has to beat the interest being paid. Asked by Bowen if pension obligation bonds were a last resort, Fornia said no and that they are a reasonable way forward.
d. McKim asked if House Bill 4 were reintroduced whether the bulk of bond proceeds would pay retiree benefits to preserve assets; Fornia agreed without confirming specific numbers.
e. Fornia invited members to come up with other scenarios combining bonds, benefit reductions and state contribution levels.
f. Speaker Stumbo asked Fornia, for future meetings, to discuss the different climate and track records that make the investing climate in Kentucky now better than in other historical examples. Fornia said he agreed with the premise of the request generally and that the current rate is pretty low compared to rates before. Fornia said that the difference between historic investment returns and interest rates is about as great as ever, but the future cannot be predicted – and, if the investment return is just 4 percent, then there's trouble. The future cannot be predicted over the next 20 to 30 years. Asked if 4 percent pension obligation bonds had ever been sold prior to the 2008 crash, Fornia said he didn't know but that there might not have been any. Speaker Stumbo then asked if that means the market is favorable for bonds and said he doesn't remember Kentucky selling any bonds in his experience since 1980 at such a low rate. Speaker Stumbo said that without $3 billion available, the state needs to ask what other alternative there is. "We owe this debt as a Commonwealth," Speaker Stumbo said. "And all this talk about shared responsibility, to me, that's not apples to apples. Y'all didn't do anything wrong. The cause of this problem, in all likelihood, lies primarily on the actions of the General Assembly in the past, and I was part of that … I think we'll be better guardians going forward … but that doesn't solve the problem that we have currently."
g. Sen. Bowen said everyone is equally committed to solving the problem but the desire is to do it in the most fiscally responsible way. Sen. Bowen asked, with the recent bonding downgrade, what is the likelihood that the state could even sell bonds in the

amounts being spoken of, and Fornia said he didn't know. Chair Karem said he would try to get bond experts back at the next meeting. In response to Adkisson, Fornia said bonding is a subset of the employer-side of funding, and a billion dollars in bonding buys about a half a percent in the state's increased contribution.

h. McKim asked if a new round of cuts for future hires would be the fourth since 2002 for teachers. Fornia said he knew of three, but the pools of teachers are different because future teachers weren't in the system during the prior cuts. But McKim pointed out that new cuts would be on top of the prior cuts.

i. Speaker Stumbo requested for Fornia to run projections based on where the 2015 House Bill 4 conference committee broke down, looking at the impact of the benefit cuts given to the committee and bonding at various incremental amounts. Fornia said he would review the items.

j. Sen. McGarvey asked if funding decisions could be expressed in real dollars for the state budget rather than in percentage of pay and what revenue streams other states have identified to use.

k. Adkisson said 80 percent of his constituents in the business community would just say switch to a 401(k) and quit bickering. For benefit of the task force, Adkisson asked Fornia to outline the financial implications of doing a conversion from just a defined benefit plan or of offering a choice to future employees. Fornia said changing to a 401(k) would shift the risk and solve the employer's problem of hitting a 7.5 percent investment return, but – because teachers, individually, won't be able to hit that mark if investment professionals can't – you wouldn't be providing enough retirement for teachers. Adkisson asked if the answer would be different if the pension were 96 or 100 percent funded. Fornia said it would only if the market was doing well and teachers would think they could outperform professional investors. But if the full funding were just the result of proper contributions without a strong stock market, the same problem would exist of teachers not being able to get needed investment returns on their own. Adkisson said he'd like to see a full range of options considered with pros and cons. He also said he hopes that the work group can develop a single solution to recommend to legislators, not just a menu.

l. Bailey said his takeaway from the discussion is that small changes in benefits make some difference but the impact on the size of the eventual benefit is much larger than the implication of a 3 percent cut (which is a percentage of pay). He also asked for quantification of the impact of potential changes on employees' behavior.

5. Feedback and general discussion: Chair Karem opened the floor to discussion.

a. Rep. Montell said constituents ask why the state doesn't go to a 401(k) and be done with it, and the answer is always that the cost would be astronomical. Montell said he believes that to be true, but it would be helpful to see specifics of converting future teachers to a 401(k). If the state's current effective normal cost is about 15 percent, to say that it would do the Social Security match and then another 4 or 5 percent for the defined contribution plan isn't beyond reason. "We certainly would want to do more than" just Social Security, he said.

b. McKim said he'd like to see information to assess the impact of benefit reductions on the ability to attract and retain quality employees, including the issue of the quality of public education and not just the financial component. Public employees operate under an assumption that what they might lack in pay will be compensated in the long run with good benefits.
c. Senate Majority Floor Leader Thayer announced that he will be unable to attend the next meeting and that Sen. Higdon will be his proxy. Sen. Thayer complimented Fornia's work in finding options that can help the state solve the problem. Thayer said the Senate has been dedicated to teachers for many years to helping solve pension problems, citing several examples of prior legislation that became law. Thayer said that, if changes hadn't been made in the KRS pension system, employer contributions would have spiked to about 65 percent. Under Senate Bill 2, those will flatten out at about 35 percent of payroll, which makes it easier for budgeting. Sen. Thayer said – not advocating either way – that a defined contribution is shared responsibility, while the employer bears the risk in a defined benefit plan. He said the Senate understands the complexity of the issue, and "we've been here for every meeting. We're dedicated to it." Sen. Thayer said the work group can pass a document that "relies almost solely on bonding," but would do so without his vote. Little support exists for bonding in the Senate, and the public overwhelmingly doesn't support bonding in private polling, Sen. Thayer said. He urged the panel to consider seriously the options Fornia offered on possible changes not covered by the Inviolable Contract for current employees and retirees and other, broader options for future employees. Also, the General Assembly could find increased dollars through budget savings to increase the already significant contribution and improve KTRS's cash flow, he said. Changes for future employees are inevitable for getting something to pass in the next session, Sen. Thayer said, calling for the work group to produce something that can pass and "not a political document."
d. Rep. Graham said that there are two houses in the legislature and that all options should be on the table, and then, through negotiations, the House and Senate can come up with a solution. Rep. Graham said he believes House Democrats would have reservations about structural changes putting this on the backs of the teachers. Rep. Graham then called for "the statesmanlike solutions."
e. Sen. Thayer responded, noting that the House passed bonding in the most recent session, but, in the Senate, "it's not just reservations. We're not for it. The people of Kentucky aren't for it." Passing House Bill 4 again will put the situation right back where it was in the conference committee. "It is an affront to the taxpayers of Kentucky if we do not consider structural changes that we have spent hours and hours

and hours in this room looking at as a reasonable part of the solution," Sen. Thayer said. Changes outside the Inviolable Contract must be considered. "The taxpayers and the private sector demand" that those changes be considered. "There is room for us to meet on this, but I'm not going to be for taking one set of credit card debt and moving it to another one."

f. Treasurer Todd Hollenbach said there is room in the middle, but any solution will cost money, and dedicated funding streams are needed. The state hasn't been paying its bills, and the money isn't easy to find. The working group needs to review what other states have done in terms of dedicated funding and guaranteeing payment. Credit upgrades are possible if a dedicated source of funds is found.

g. McKim said his understanding is that HB4 would have refinanced 7.5 percent debt to 4.5 percent debt. Most people understand that refinancing is a good thing, he said, and he believes the support is there if it's refinancing taxpayer funds to the lower rate.

6. Adjournment: Chair Karem referenced a country song that all gain a lot when they give a little. The meeting was adjourned at 1:47 p.m. until Nov. 6.