KENTUCKY TEACHERS' RETIREMENT SYSTEM FUNDING WORK GROUP
Notes of Meeting Nov. 16, 2015

A meeting of the Kentucky Teachers' Retirement System Funding Work Group was held on Friday, Nov. 16, 2015 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; Gary Harbin; Treasurer Todd Hollenbach; Secretary Mary Lassiter; Brent McKim; Sen. Morgan McGarvey; Dr. Tom Shelton; Dr. Robert Wagoner; and Wayne Young

Also Attending: Kelly Dudley (on behalf of Speaker Greg Stumbo); Ed Ross (on behalf of Secretary Lori Flanery); Sharron Burton (on behalf of Secretary Dinah Bevington); Rep. Brad Montell (on behalf of Rep. Jeff Hoover); Auditor-elect and Rep. Mike Harmon; Tom Bennett (on behalf of Auditor Adam Edelen); and Perry Papka (on behalf of Brigitte Blom Ramsey)

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

1. Chair Karem convened the meeting at 10:07 a.m.

2. Introductions and announcements: Chair Karem said everyone shares a real commitment to reassure teachers and retirees that a sincere effort is being made to come up with positive options to handle the pension funding situation, which is a problem and a challenge – but is not in danger of insolvency overnight. The work group participation has been great, and hopefully will lead to a report of good recommendations for the new governor and 138 legislators to use.

3. Update on bond market: Bill Mack of Morgan Stanley and Ryan Barrow from the Finance and Administration Cabinet reappeared before the Funding Work Group as a follow-up to their July presentation.

a. Mack summarized his testimony from the July meeting, including reitterating that a pension obligation bond (POB) issuance can be neutral if structured correctly or can negatively impact the state's credit rating if it's not. Mack said there is a lot of volatility in the market but equities have trended higher, and the volatility has moderated somewhat. A rate increase is expected in December. The bond market is similar to what it was in July.

b. Barrow discussed bond ratings, which are independent assessments that the state pays for in its transactions. In June of 2014, Moody's revised Kentucky's outlook from negative to stable on general obligation bonds. In September of this year, Standard & Poor's downgraded Kentucky's bond rating, speaking about the "chronic underfunding" of pensions. It is the biggest credit issue facing the Commonwealth and wasn't a surprise since S&P's earlier reports had signaled a downgrade. A recent Moody's report also spoke of the importance of addressing the underfunding in the next session. Barrow presented a series of three debt rankings for the state where Kentucky ranked between 40th and 42nd. Lower interest rates mean less debt paid by taxpayers, while a higher rate means less capital for infrastructure.

c. In response to Mary Ann Blankenship, Barrow clarified that rankings mean Kentucky's debt load is among the highest in the country.

d. Mack, speaking of the size of bond issuances, said that a $1 billion issue isn't the norm but also isn't entirely uncommon. Many occurred in the 2009-11 period, and the most recent was a $1.1 billion pension bond offering by Kansas. Kansas had similar, but slightly higher, ratings than Kentucky's. Kansas considered whether to bond in one or multiple transactions and decided to do it in one transaction. A Moody's report a day or two before releasing the Kansas bonds was somewhat negative because the bonds were viewed as budgetary relief.

e. In response to Sen. Joe Bowen, Mack said he didn't know where each state that bonded ranked among the states, and he would follow up. Mack also said not many were pension obligation bonds. Bowen said it matters if the states were among the least indebted states, where "they're not layering on the debt that we might be." Mack said Kansas and Illinois were similar, but he would provide more information.

f. In response to Sen. Morgan McGarvey, Mack said he didn't know how Kansas arrived at the $1 billion number. Kansas did a POB in the early 2000s and it went well for them, so leaders there believed the POB to be a good option again as they grapple with budgetary strains. Mack said he believes the bonds were more about budgeting than shoring up the pension fund.

g. Brent McKim said his understanding is that a POB wouldn't be so much adding debt as refinancing existing debt, rather than being viewed as additional debt. And, ideally, that wouldn't be viewed any worse than the previous debt load. In response, Barrow said Moody's ranking system is closest to making pension debt synonymous with general debt. Other factors would be considered, Barrow said, adding that it would be negative-to-neutral. In response to McKim, Barrow said any scenario where bonding could be viewed as a positive would be fact dependent as it relates to having a solution to a pension funding issue.

h. Gary Harbin said a bond manager told the KTRS Investment Committee last week that it looks at pension debt in the same way as other debt when determining whether a state is a risky investment.

i. In response to Jason Bailey asking about how bond raters view bond debt versus pension underfunding, Barrow said it's fact dependent. If there is no plan, there will be a further deterioration of credit ratings. Mack said that whatever the legislature decides, "it has to be a credible plan and one in which it gets to that ARC funding at some point."

j. In response to Karem, both presenters said the current underfunding of teachers' pensions is hurting Kentucky's bond rating.

k. In response to David Adkisson asking about whether a lack of a plan in 2016 will further erode Kentucky's credit rating, Barrow said it would, based on comments from ratings agencies. "They have all telegraphed the importance of next session," he said.

l. In response to Rep. Mike Harmon asking if borrowing at one rate and getting an investment return at a lower rate would negatively impact credit ratings, Mack said it's not necessarily a negative if it prevents liquidating better, higher-earning assets and serves as a bridge. Mack also said he believes a Kentucky bond issue now would be looking at 5 to 5.5 percent.

m. In response to Sen. Bowen asking how much could Kentucky sell in the bond market, Barrow said in Kansas, the underwriter had to take down about $100 million, which was 10 percent of the bond. A large number is possible, but at a higher interest rate. Barrow said he would like flexibility, starting at about $1 billion to $1.5 billion and then coming back later if interest was sufficient. Mack said Illinois' $10 billion was the largest POB, an amount that was upsized because of its immediate success. Bowen said there is a limit, and, in his estimation, it's probably $1 billion. Mack said he wouldn't call it a ceiling, noting that a number of states have done larger amounts. "Having a healthy respect for the marketplace is the right method when you go to execute on whatever the legislature's plan is," Mack said.

3. Recap October 16 meeting: Chair Karem recognized William "Flick" Fornia to recap the previous meeting.

a. In response to Rep. Brad Montell, Fornia said sick leave and COLAs go on forever in terms of normal cost, even if bonds are retired. Harbin said the cost of sick leave is 1.25 percent of pay annually, and 0.6 percent of that is part of the Inviolable Contract.

b. Blankenship said no magic bullet exists, so every incremental change that can be made ought to be reviewed.

c. As the discussion continued, Fornia said that even with hefty benefit cuts for future teachers, the "legacy" liabilities for retirees and current teachers still would cause the fund to run out of money.

d. In response to Sen. McGarvey, Fornia said a 3 percent of pay reduction in benefit is a 19 percent cut in the take-home benefit.

e. In response to McKim asking about the scenario being evaluated that would require a 3.64 percent contribution, Fornia said he isn't aware of any employers in the state that pay less than 6.2 percent of pay for their employees' retirement funds. But even with a 3.64 percent contribution, Fornia said the Kentucky teachers' pension would be a better benefit than Social Security.

f. In response to Sen. Bowen, Fornia agreed that missing the target on investment returns in his scenarios could make futile all the structural changes in the world. In response to Robin Morley asking about one scenario that used a 6 percent return on investments instead of the 7.5 percent used by KTRS's actuaries, Fornia said the model's 6 percent assumption was a permanent assumption.

g. In response to McKim asking about the Kentucky system of backfilling what the statutory contributions don't cover, Fornia agreed it's not as responsive to market fluctuations as some other states are where the actuary comes in each year and just tells a city or state the number they need to meet. He said about half the public pensions are structured that way. "It is the way to make sure you hit the bullseye," Fornia said. Kentucky's system currently is crossing fingers that 25 to 28 percent of pay will fund the pension, and it doesn't. The other way is preferred by ratings agencies, he said. Chair Karem said that's analogous to why the county system is in a better situation because those governments just get a bill and pay it.

4. Chair Karem recognized new Education Commissioner Stephen Pruitt, who addressed the Funding Work Group. He said the work of the funding group is important and will impact the future of education in Kentucky. He also said he appreciates the group's work on the behalf of the education community.

5. Review Draft Principles: Chair Karem discussed a draft list of guiding principles for the work group. After some discussion among members about possible principles and recommendations, Chair Karem agreed to the request by Sen. Bowen that members be given more time to review the principles and offer changes.

6. Additional analyses requested: Fornia then reviewed the results of additional analyses requested.

a. Fornia discussed a scenario of increasing the contribution by 1 percent (about $35 million) a year for 12 years.

b. In response to Bailey and Rep. Montell, Fornia said his 12-year scenario assumes that money currently going to pensions, including the special appropriation and bonding debt service, continues in addition to the increased contribution.

d. In response to Bowen, Fornia said the 1 percent-a-year phase in depends on investment returns of 7.5 percent. Fornia also said he would create a chart showing why the math behind his estimate works compared to what members were previously told.

e. In response to Secretary Mary Lassiter, Fornia said eliminating all the violable benefits for existing teachers would reduce the post-tax pension for a teacher retiring at $70,000 by 4 percent.

f. Fornia said there is no economic value for putting teachers in Social Security. Teachers receive substantially more from the pension. While both they and the state put more in financially, the teachers receive a more valuable benefit and would receive less under Social Security. Negligible savings from a switch would be more than offset by the cost of another type of benefit to supplement Social Security.

g. In response to McKim, Harbin said closing the plan to new hires would mean investments would have to be shorter term and the annual required contribution would go up to make up for the investment performance.

h. Fornia addressed the disadvantages of defined benefit contribution plans because individuals do not know their life expectancy, must invest conservatively as they get older and are not as good at investing as professionals. The disparity for an employee/retiree can be half of the value of their retirement.

i. In response to Adkisson, Fornia said he could provide more detailed numbers about the various possibilities the state could pursue.

j. Fornia discussed risk-sharing options under a defined benefit plan, such as are used in Nevada and Missouri. In those, the contribution rate is determined each year and shared by the state and the employees.

k. Fornia said studies show that dedicated revenue streams have been shown not to work.

7. The meeting was adjourned at 2:01 p.m., until the final meeting on Dec. 1 at 10 a.m.