KENTUCKY TEACHERS'RETIREMENT SYSTEM FUNDING WORK GROUP
Notes of Meeting Dec. 1, 2015

A meeting of the Kentucky Teachers'Retirement System Funding Work Group was held on Tuesday, Dec. 1, 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; Rep. Derrick Graham; Gary Harbin; Treasurer Todd Hollenbach; Mary Lassiter; Roger Marcum; Brent McKim; Sen. Morgan McGarvey; Dr. Tom Shelton; Speaker Greg Stumbo; Sen. Damon Thayer; Dr. Robert Wagoner; and Wayne Young

Also attending: Bryan Sunderland (on behalf of David Adkisson); 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); Perry Papka (on behalf of Brigitte Blom Ramsey); Sen. Jimmy Higdon; Rep. David Floyd; Rep. James Tipton; Rep. Michael Meredith; Rep. Jerry Miller; and Rep. and Auditor-elect Mike Harmon

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

1. Chair David Karem convened the Funding Work Group at 10:07 a.m., and requested that members and participating guests introduce themselves.

2. Follow-up items: Chair Karem recognized William "Flick"Fornia to recap his presentation from the previous meeting and present information on topics upon which members sought elaboration.

A. Discussing the scenario presented at the previous meeting regarding a 12-percent contribution increase that would be phased in over 12 years, Fornia said that his model assumes that funds currently paying off bonds, the savings from 2008 benefit cuts and the special appropriation costs are all continued and dedicated to the pension system. The reason for the difference in the figure presented earlier to the Funding Work Group of needing to make up for a 14 percent of pay increase to cover underfunding is because the 14 percent does not include future hires, nor does it reflect dedicating the special appropriation or debt service to the pension system on a long-term basis.

B. Fornia said the 1 percent per year increase, however, may not be viable because it doesn't address the cash flow needs of KTRS and may not be viewed seriously by the bond rating agencies. As an alternative, Fornia also outlined a scenario for a 12-percent increase that would be a 5 percent hike immediately and then a 1 percent increase for each of the following seven years. Fornia said that would get KTRS to full funding in 30 years and help cash flow more up front.

C. Regarding the feasibility of a defined contribution plan, Fornia reiterated the challenges that such a plan presents for individuals versus the security given to them by a defined benefit plan. In addition to what he presented at the previous meeting, Fornia said that a lower benefit from a defined contribution plan could put some retirees on public assistance and said closing the defined benefit plan would result in lower investment returns for KTRS as it would have to be more conservative in its investing.

D. Putting numbers to that concept, Fornia said his model for a defined contribution plan assumed a 9.11 percent contribution from teachers and a 6.58 percent contribution from the state, mirroring contributions to the current defined benefit plan. The defined contribution plan would result in a 29 percent reduction in benefits for retired teachers. It also would nearly double the state's cost to 12.1 percent of pay after the costs are factored for public assistance for retirees who could be below poverty and the increased cost of the annual required contribution when KTRS makes its asset allocation more liquid. Alternatively, to make the benefits from a defined contribution plan equal to the current retiree benefit, Fornia said that the state's cost would increase by 2.7 times to 17.9 percent of pay.

E. In response to Bryan Sunderland, Fornia said he did not model a retirement package that combined Social Security and a defined contribution plan because the lower benefits that Social Security would provide make it less efficient than a straight defined contribution plan.

F. In response to Sen. Joe Bowen asking why the private sector goes to defined contribution plans if defined benefit plans are less expensive, Fornia said the defined contribution plan reduces the risk that private companies face. States have more time to manage the ups and downs of investment returns than corporations that are focused quarter to quarter. Alluding to past comments that General Motors, when it teetered on bankruptcy, was an insurance plan that made cars on the side, Fornia said, "I don't think Kentucky will ever be a pension fund that's a commonwealth on the side."

G. In response to Brent McKim, Fornia said his models mean the annual required contribution (ARC) would increase by 4.9 percent of pay – or about $170 million – because KTRS would be forced to change its asset allocation.

H. In response to Mary Ann Blankenship, Fornia said the costs of the defined contribution plan would be in addition to the current unfunded liability of the defined benefit plan.

I. Sunderland asked for the costs associated with closing the defined benefit plan to be segregated out, since some of the costs in Fornia's estimates would go away as the closed defined benefit plan was retired. Fornia said there wouldn't be a lower cost, only a less risky cost, and it would be roughly 80 years before the old plan actually goes away.

J. Chair Karem said he can't imagine the work group supporting any scenario that would make educators, who are entrusted with teaching our children, consider public assistance.

K. Fornia presented a comparison of employer costs for teacher pensions in surrounding states.

L. In regard to an earlier chart showing Kentucky's employer contribution rate has been stagnant in recent years compared to most other states, Rep. Brad Montell asked how Kentucky's contribution compared 15 years ago when the funding ratio was near 90 percent. Fornia said the same research showed that Kentucky's contribution was about average, or if it was higher, it wasn't much above average.

M. In response to Sunderland, Fornia said that Kentucky's needed employer payments are higher for teachers' pensions than some other states because of having to catch up on funding, not the cost of the plan itself.

N. Gary Harbin said that in 1999, the legislature allowed some contributions to be transferred to the medical insurance fund and also cautioned, in surrounding state comparisons, that only Ohio has to deal with retiree health care to the extent Kentucky's teacher pension system does.

O. In response to Sen. Bowen about the surrounding state comparisons, Fornia said he doesn't see anything in the funding comparisons that would suggest Kentucky is at risk of losing prospective teachers to those states. However, Fornia said he believes teachers make decisions on where to work based upon the quality of benefits rather than funding levels. If a new benefit tier is made in Kentucky that reduces teacher benefits, then there is a risk of prospective teachers looking at other states for employment.

3. Guiding principles: Chair Karem recognized Robin Morley to coordinate the drafting of the guiding principles.

A. Six principles on the draft report received no requests for changes, and Morley suggested that they be considered adopted if no one objected, which no one did. The six are numbered 1, 2, 4, 6, 7 and 9.

B. Principle 3 was adopted with the suggested alternative language in the draft report.

C. Principle 5 was approved with the deletion of the phrase "to a lesser extent."

D. A significant number of comments were received on the proposed Principle 8.

i. Senate Majority Floor Leader Damon. Thayer requested with No. 8 and other proposed principles that words like "must" and "shall" be avoided, using, instead, words like "urge" and "should."

ii. Blankenship recommended using the language for No. 8 suggested by senators Bowen and Thayer. No one objected.

iii. Rep. Brad Montell said his concern with the recommendation is that it does not address reducing the employer risk over time. He suggested that there be some language about reducing future risk for the state.

iv. David Adkisson said an addition he suggested is aimed at conveying the need to satisfy bond rating agencies in whatever is done with pensions. At Chair Karem's suggestion, and without objection, language to that effect was added to No. 8.

E. Regarding Principle 10, the alternative language changing "must" to "should" and "constructed" to "demonstrated" was approved along with an additional sentence that speaks to the need for a solution that minimizes the untimely sale of assets to pay benefits.

F. Sen. Jimmy Higdon said he is concerned that suggested changes to Principle 10 are laying the groundwork for bonding. Chair Karem said there is no such intent and that he doesn't read it that way.

G. Speaker Greg Stumbo said he would like to see recommendations about tangible solutions, including a source for the money to address the underfunding, and not just a call for more discussion.

H. Chair Karem said that specific solutions would be discussed later in the meeting.

I. Sen. Bowen said he agrees with Speaker Stumbo's point, but the speaker should understand the effort made by members of the work group to reach the point members are at now and that the speaker's points should have been made earlier in the process.

J. Principle 11 was adopted.

4. Components of a Comprehensive Solution: Discussion commenced with the issue of increased contributions.

A. Senators. Bowen and Thayer suggested a new paragraph about the downsides of pension obligation bonds (POBs). McKim said the proposed language overstates the risks. Sen. Bowen said he believes the language as proposed is factual. Fornia said the description of "devastating" results is too strong and that the results of most pension obligation bonds have been positive. Fornia also questioned that the Government Finance Officers Association (GFOA) recommendation against POBs was a consequence of prior POB results.

B. Fornia suggested changing "devastating" to "disappointing" and deleting "Consequently."

C. Blankenship questioned to the use of the GFOA policy when it had not been presented to the work group at any prior meeting.

D. Harbin said GFOA also would say full funding of the ARC is imperative. He also said POBs as a sole solution are inadvisable but deserve discussion as a way to step into the ARC. He suggested that Kentucky is in a rare circumstance that would be an outlier to the GFOA opinion.

E. Mike Armstrong read another GFOA opinion that said POBs should not be a sole solution.

F. Tom Shelton said the GFOA report cited by the senators is based on five specific reasons and those reasons should be addressed.

G. Chair Karem suggested just using the first sentence of the senators' proposal. McKim suggested just using the first sentence and attaching the GFOA advisory and a Boston College report.

H. Blankenship moved, and Marcum seconded, that the first sentence be used. Treasurer Todd Hollenbach suggested simplifying the first sentence by saying "if the returns on the money invested" instead of interest. His motion to amend received a second and was approved.

I. The addition was then approved as amended.

J. At the suggestion of Jason Bailey, the sentence on page 10 beginning with "Additionally" was deleted.

K. Fornia suggested deleting the lines in the chart on page 10 dealing with the 12-year, 1-percent-a-year phase in for an increased contribution. Blankenship suggested striking the reference to future members from the chart as well. Both changes were approved.

L. McKim suggested a sentence be added at the outset of the section on comprehensive solution components saying that illustrative examples of those components are included.

M. Harbin suggested that an assumption of the table, specifically that the existing special funding for pensions (colloquially known as "green box" and "yellow box" dollars), be put in writing.

N. Speaker Stumbo questioned the language on POBs on page 9 and said it could be used to scare people. Sen. Higdon said the language says the state shouldn't rely solely upon bonding. After discussion about possible changes, Wayne Young suggested language that POBs "may have a role to play if the issuance is part of a more comprehensive plan to address pension shortfalls."

O. Blankenship moved that a recommendation be made (on page 6 of the report) that the "green box" and "yellow box" dollars stay with KTRS to help address the pension liability. Rep. Montell said he isn't convinced that the "green box" dollars go away, although he supports the concept of the motion. He suggested that the motion be clarified to say that those funds would be dedicated to the pension fund as they become available. Blankenship accepted the change as part of her motion. The recommendation was approved by voice vote.

P. The group then discussed the benefit adjustments section of the report. After a discussion about how Kentucky's benefits compare nationally, a suggestion was made by Blankenship to put the Pension Trustee Advisor charts from earlier meetings and today's surrounding states chart in the report. The report will include a sentence that Kentucky's benefits for future, early-retiring long-tenured educators are more generous than contiguous states.

Q. Rep. Montell suggested that current teachers pay for their benefits that are outside the inviolable contract with a phased-in contribution increase of between 1.5 percent and 2 percent.

R. In the section on current teachers, a bullet point suggested by senators Thayer and Bowen was added saying that some of the added health care costs caused by benefit changes for current teachers might be offset to the benefit of school districts by the lower salaries of new teachers.

S. Morley discussed changes to the rest of the report dealing with future teachers, increased member contributions and defined contribution plans.

T. Rep. Montell asked about the decision that the Funding Work Group will not be recommending a single solution. Chair Karem said it became clear earlier that a single recommendation would not be reached by the group, so it was suggested that a range of alternatives could be presented to legislators. Rep. Montell said he understood and that his question was for clarification.

U. Harbin requested for an elaboration in the report, beyond the sentence in the draft, on Fornia's previously stated reasons why Social Security is not a good option for teachers or the state.

V. McKim suggested that language be added that the 6.6 percent of pay normal cost for the current pension plan for hires after 2008 is a value, for instance, compared to Social Security. Sen. Higdon requested that an explanation be added that the normal cost isn't always sufficient when returns don't meet expectations or other factors impact the pension plan. "There's nothing normal about it," he said.

W. Sen. Bowen said a defined benefit plan is better if the investment return is met; otherwise, it's not a better deal. Fornia said, however, it's still a better deal regardless of whether returns meet assumptions by virtue of the fact that Social Security is invested in treasury bonds. Also, Social Security is skewed to lower-paid individuals than teachers.

X. Adkisson said he believes what the Funding Work Group has produced is useful, but he hopes many members will continue to talk in an attempt to reach consensus. He also asked for a recommendation to the legislature that the issue be addressed early in the session, rather than left to the last days of the session. Sen. Thayer said he appreciates the sentiment but sessions take on lives of their own and the request is kind of Utopian. The senator also said the pension issue is tied into the budget, which often is decided in the final hours of the session. Chair Karem said individual groups and members can convey to legislators the importance of a pension solution to legislators.

Y. Sen. Bowen said "we are committed to finding a solution," noting the Senate's work in the Kentucky Retirement Systems legislation in 2013. "We're not going to sit around and twiddle our thumbs and procrastinate on this. We're committed to finding a solution. That solution may not look like this document. It may look like portions of this document, and we'll not be the only players in the final outcome of this. But I want to make it very plain, very clear that there is a commitment by the General Assembly of Kentucky to resolve this issue and, in doing that, not take our eye off the ball of the challenge that we face with KRS (Kentucky Retirement Systems)."

Z. Armstrong said the work of the group has been encouraging, and he hopes members and constituent groups work with legislators during the session as they try to find and enact a solution.

5. How to Finalize the Report of the Work Group: Chair Karem said a copy of the final report will be distributed to members and, if they have objections, those can be submitted in writing and will be made an appendix to the report.

6. Chair Karem thanked Fornia for his work, the members of the task force for their work during the process, the participation by legislators who weren't officially on the panel, the attendance of retired teachers and the dedication by Morley in assisting the work group.

7. Chair Karem asked for all in favor of the report to vote accordingly. The KTRS Funding Work Group report was approved on a voice vote, as amended and with the ability of members to add comments as appendices.

8. Chair Karem adjourned the Funding Work Group at 2:32 p.m.