KEEPING THE PROMISE

Public Pension Oversight Board

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Definitions

- **Retirement age** - This is the age at which an employee earns retirement benefits without any reduction or penalty for retiring early. It is <u>not</u> the time at which an employee must retire, or is even encouraged to retire.

- **Solvency** – This relates to the ability to pay all debts, that is, to meet its long-term financial obligations. An organization's solvency can be viewed from two perspectives -- an organization is insolvent if:
  - (1) it does not have enough <u>liquid</u> assets to meet near-term obligations and
  - (2) if the <u>value</u> of its assets is less than its liabilities.

For many insolvent organizations, bankruptcy is an option. For non-government pension plans, federal rules require the termination of plans that are less than 60% funded.

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The Commonwealth sponsors 8 pension plans and 8 post-retirement health benefit plans

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Kentucky Retirement Systems ("KRS")

- Kentucky Employees Retirement System ("KERS")
  - Non-Hazardous ("KERS-NH"); Hazardous("KERS-H")
- State Police Retirement System ("SPRS")
- County Employees Retirement System ("CERS")
  - Non-Hazardous ("CERS-NH"); Hazardous ("CERS-H")

Teachers' Retirement System of Kentucky ("TRS")

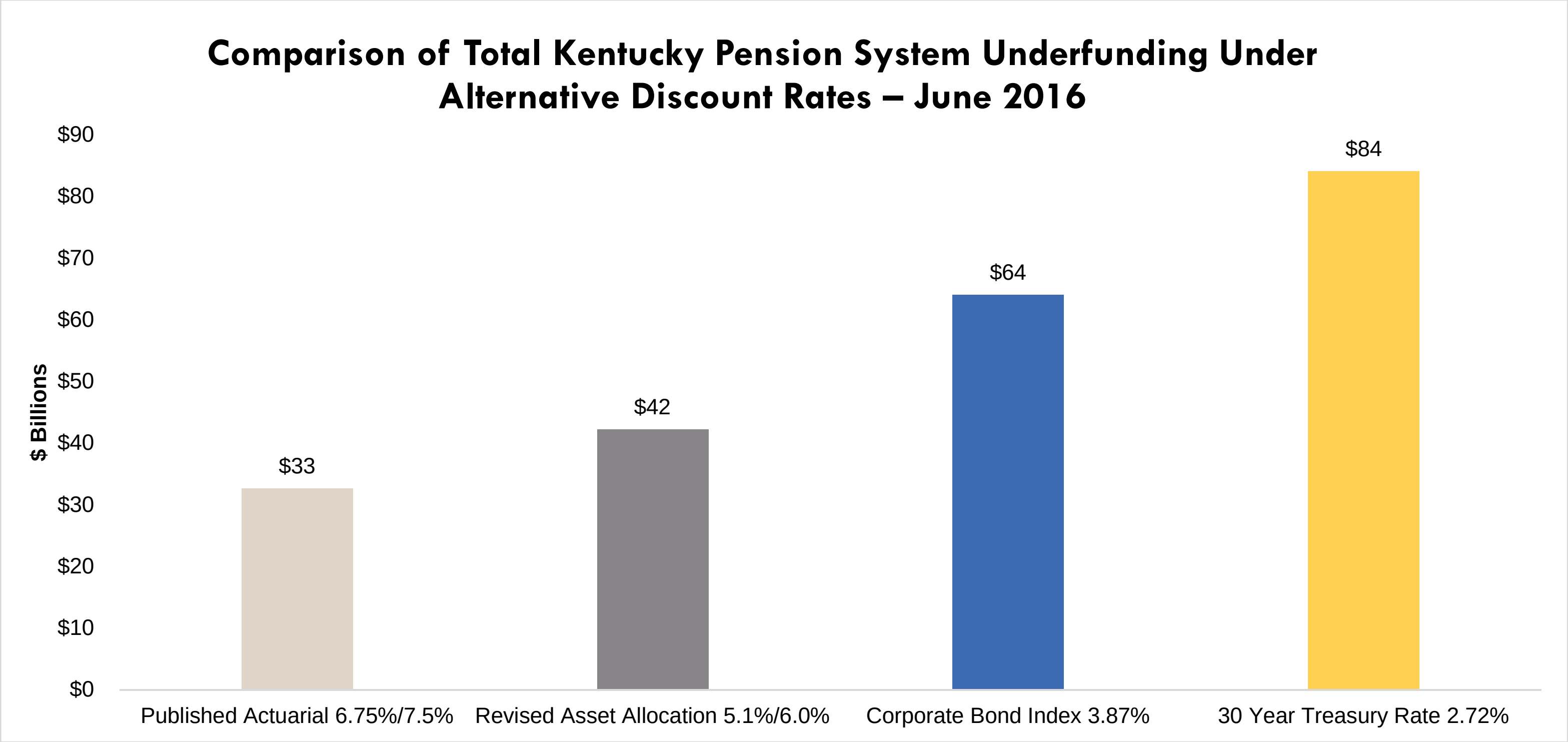
Kentucky Judicial Form Retirement System ("KJFRS")

- Legislators' ("KLRP"); Judicial ("KJRP")

Pensions are Severely Underfunded

FY2015 Worst-Funded Pension Ratios Aggregate of State Liabilities		
	Median	**74.6%**
	Average	**73.2%**
46	Rhode Island	55.5%
47	Connecticut	49.4%
48	Illinois	40.2%
49	New Jersey	37.8%
50	**Kentucky**	**37.4%**

How much are the Pension Plans Underfunded?



Source: KRS, TRS, KJFRS Valuation Reports, PRM Consulting Group

$7 Billion Negative Cash Flow from FY2006-FY2016

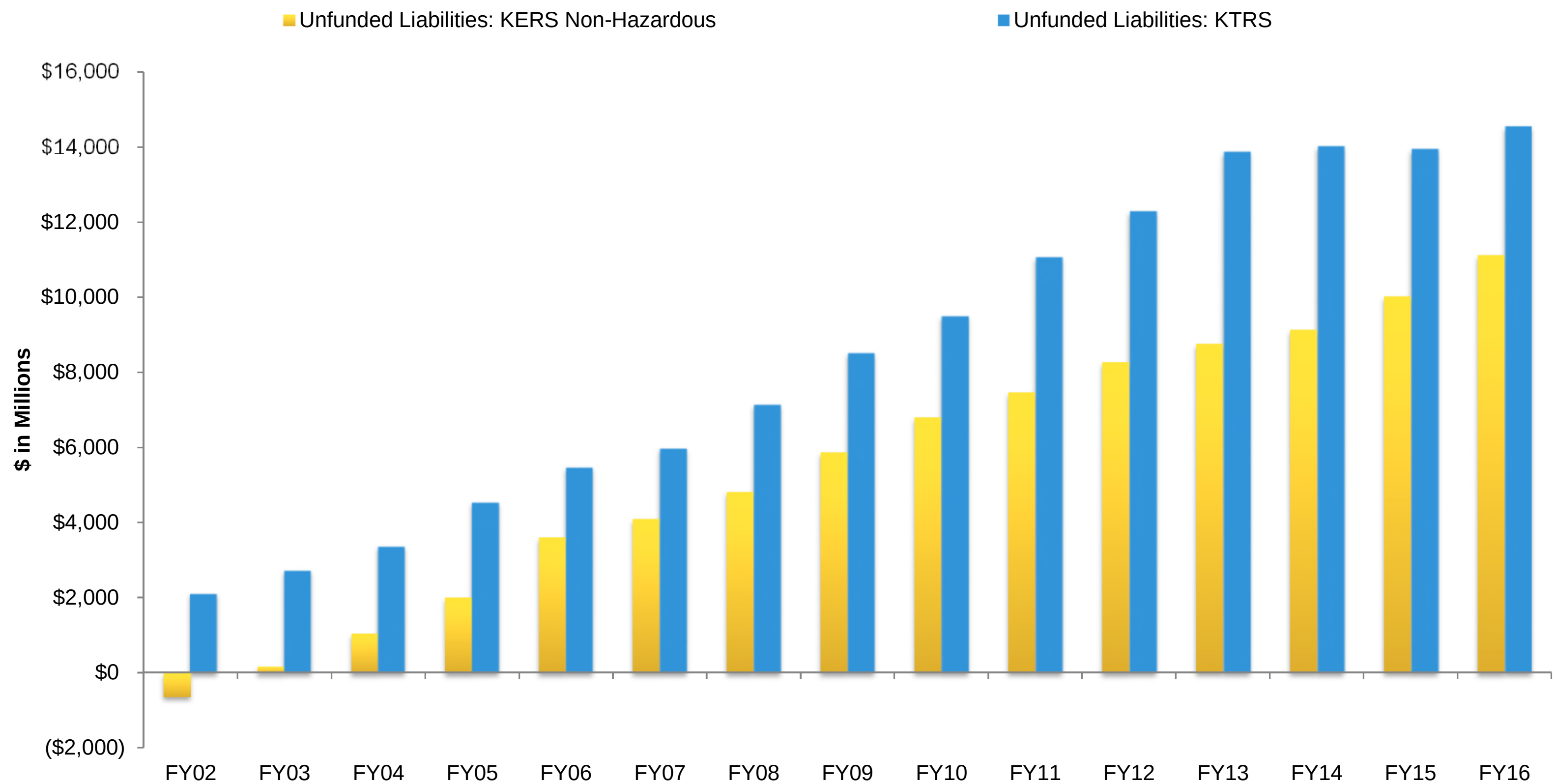
Total Kentucky Pension Fund Cash Flows FY2006-FY2016 Inflows + Interest/Dividends – Outflows ($ in 000s)			
Fund	**Inflows**	**Outflows**	**Cash Flow**
KERS-NH	$4,792,048	$9,061,781	$(4,269,733)
KERS-H	477,393	502,187	(24,794)
SPRS	304,008	512,277	(208,269)
CERS-NH	5,428,274	5,744,284	(316,010)
CERS-H	1,942,982	1,780,890	162,092
TRS	13,612,859	15,866,112	(2,253,253)
Total	$26,557,564	$33,467,531	$(6,909,967)

Negative Cash Flows Projected to Continue at TRS

TRS Pension Fund Projected Cash Flows Based on June 30, 2016 Valuation and Assumptions: 7.5% Earnings, 3.5% Payroll Growth Annually Inflows - Outflows ($ in 000s)			
Year	**Inflows**	**Outflows**	**Cash Flow**
FY16	878,499	1,841,835	(963,336)
FY17	1,364,932	1,964,173	(599,241)
FY18	1,380,628	2,054,888	(674,260)
FY19	1,446,733	2,127,401	(680,668)
FY20	1,469,823	2,200,779	(730,956)
FY21	1,525,999	2,273,937	(747,938)
FY22	1,607,509	2,373,992	(766,483)
FY23	1,686,030	2,429,201	(743,171)
FY24	1,742,259	2,507,931	(765,672)
FY25	1,799,455	2,590,340	(790,885)
FY26	1,856,506	2,674,843	(818,337)

Source: Cavanaugh MacDonald
Note: does not include dividends/interest or other investment earnings

The Unfunded Liability of Kentucky's Two Largest State Pension Systems has Increased Dramatically



Why are the plans underfunded?

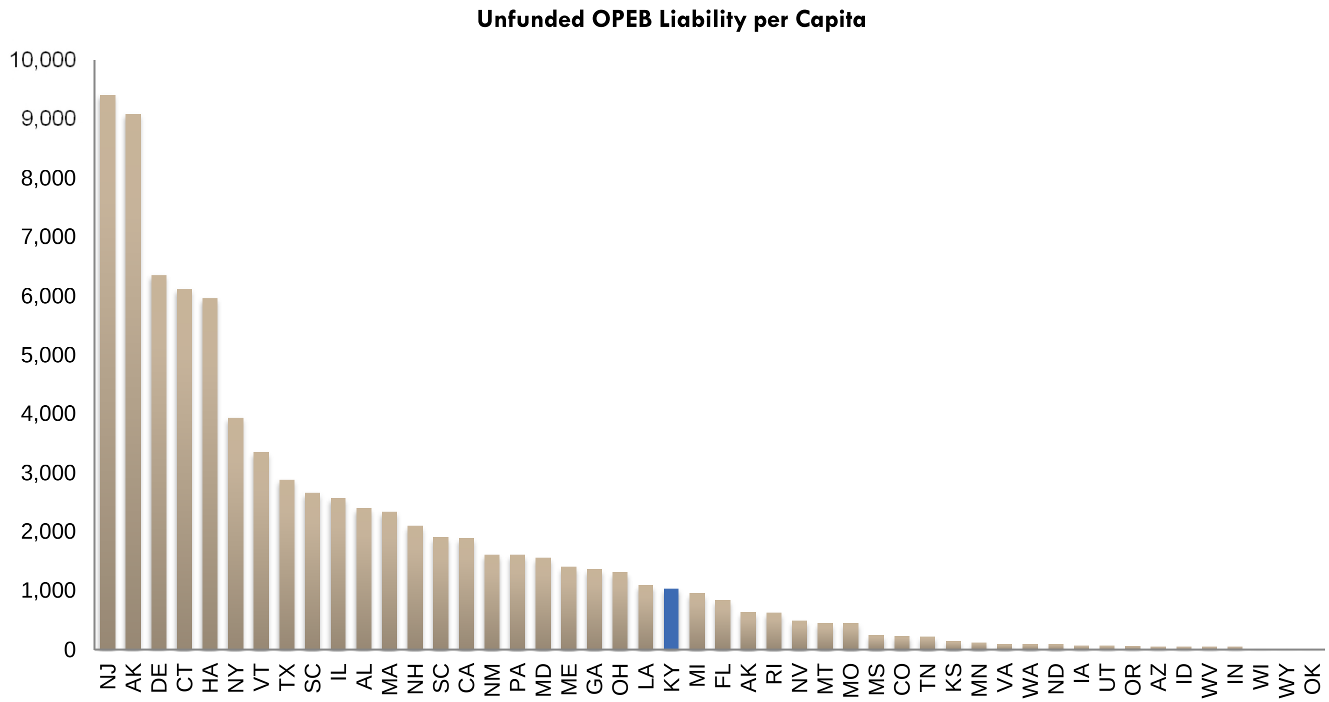
Investment	
Market performance less than assumption	15.0%
Plan performance less than market	8.0%
	23.0%
Funding	
Funding less than the ARC	15.0%
Structural issues	
Funding method: actuarial backloading	25.0%
Actuarial assumption changes	22.0%
Unfunded COLAs	9.0%
Plan experience	6.0%
	62.0%
	100.0%

Underfunding: Summary by System

Factors Increasing the Unfunded Pension Liability 6/30/2005 to 6/30/2016: Amounts in $Millions										
Causes	TRS	KERS-NH	KERS-H	CERS-NH	CERS-H	SPRS	KJRP	KLRP	TOTAL	
Actuarial Back-loading	$3,278	$1,153	$89	$1,269	$353	$111	$31	$2	$6,286	25%
Actuarial Assumption Changes	1,958	2,319	82	984	249	50	25	5	5,672	22%
Plan Experience	232	539	39	372	107	107	43	2	1,441	6%
Investment: Market Performance Below Assumption	1,926	639	80	931	297	45	5	2	3,925	15%
Investment: Plan Performance Below Market	1,014	610	(5)	207	82	8	14	0	1,930	8%
Funding Less Than the ARC	1,588	2,561	(10)	(220)	(133)	42	(11)	3	3,820	15%
COLAs	0	1,291	68	672	267	72	27	3	2,400	9%
	$9,996	$9,112	$343	$4,215	$1,222	$435	$133	$17	$25,473	100%

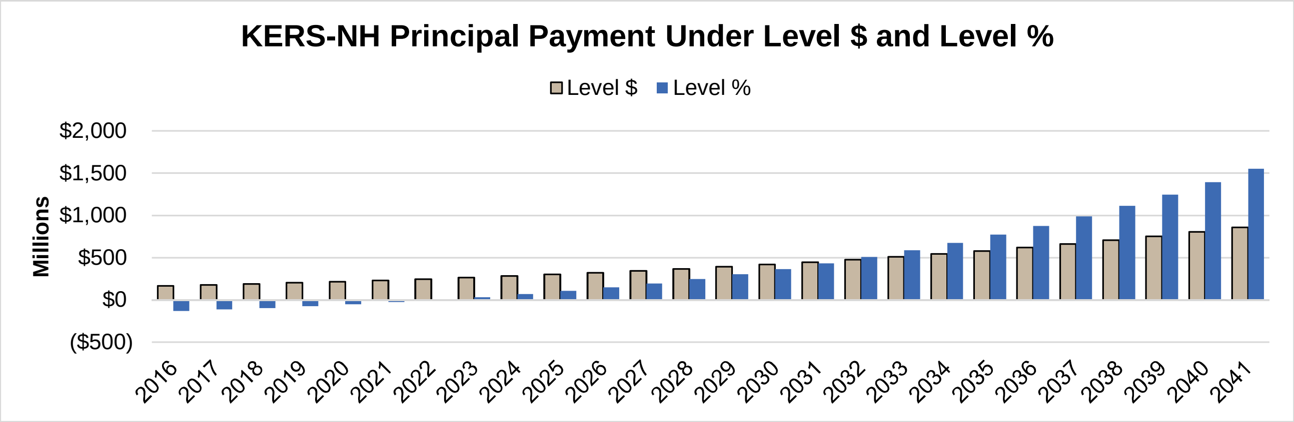
Source: PRM Consulting Group

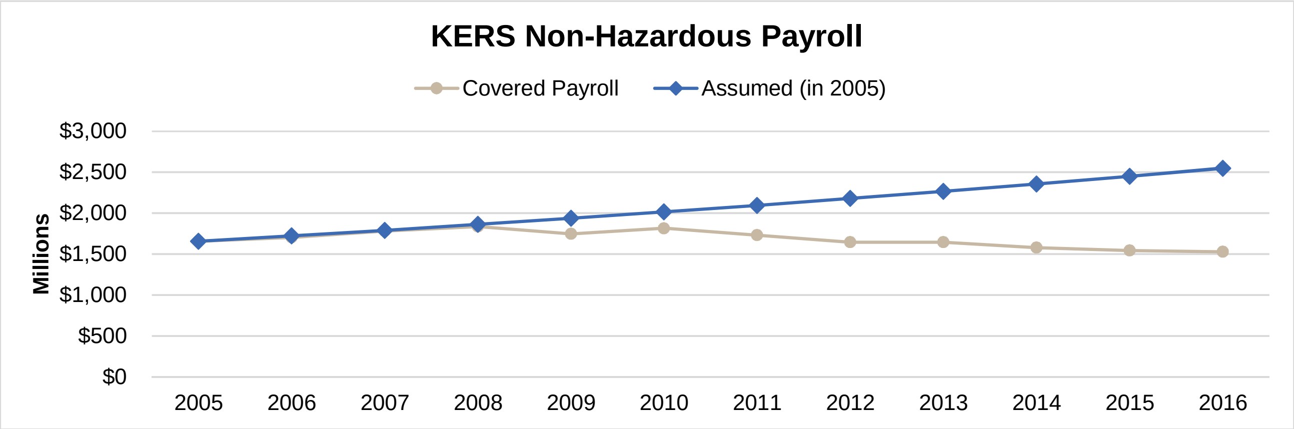
Kentucky's OPEB (Retiree Healthcare) Liabilities are Relatively Better-Funded



Source: Standard & Poor's, Rising U.S. State Post-Employment Benefit Liabilities Signal An Unsustainable Trend, September 7 2016. Note: Nebraska and South Dakota have no OPEB liability. Liabilities are as reported for the most recent valuation date available, between 12/31/2013 and 6/30/2015.

Actuarial Back-loading Illustrated

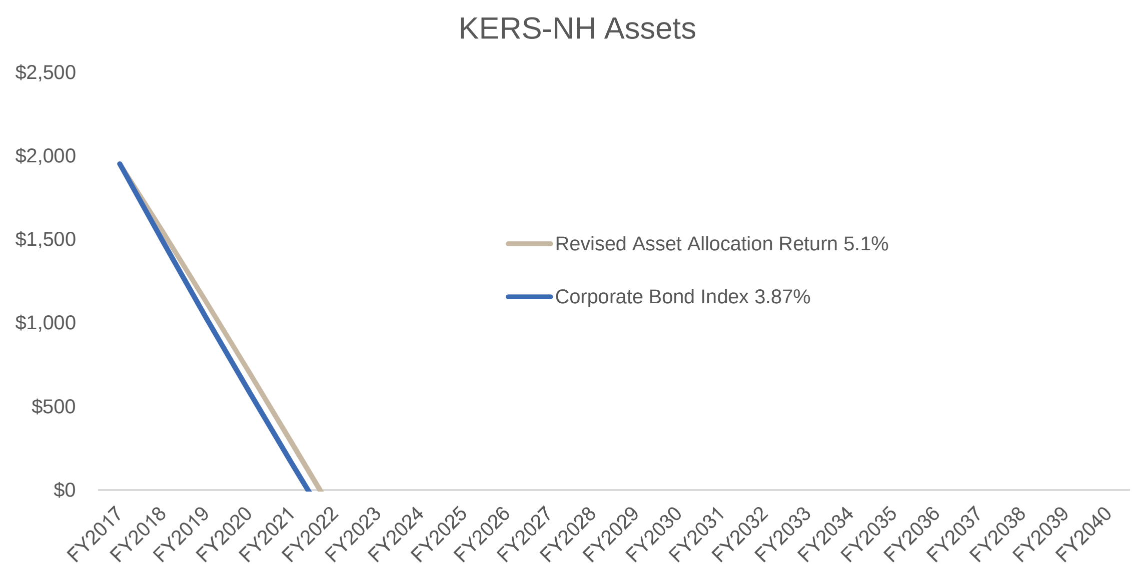




Source: PRM Consulting Group

Solvency Analysis

If future funding of KERS-NH reverted to the prior, pre-FY2016 patterns of funding roughly 60% of the ARC, assuming 0% payroll growth, the plan is projected to go insolvent within several years, even if the published actuarial return assumption is met



Source: PRM Consulting Group

The TRS and CERS-NH plans are in good shape -- aren't they?

- If state government plans were subject to federal standards for single-employer private plans, the Internal Revenue Code would <u>require that all benefits be frozen</u> in TRS and CERS-NH . This is true even using the erroneous 2016 actuarial assumptions, not the more conservative and realistic discount rates and other assumptions <u>required</u> of private plans.

The TRS and CERS-NH plans are in good shape -- aren't they?

NO. TRS and CERS-NH plans are NOT in good shape.

- Using the same investment rates of return that corporate plans are required to use – the Corporate Bond Index rate – the TRS unfunded liability goes from $15 billion to $34 billion and the CERS unfunded liability goes from $5 billion to $9 billion.
- Using the same Corporate Bond Index rate that is required of all private pension plans, the aggregate underfunding for all eight of Kentucky's plans goes from $33 billion to $64 billion.

The TRS and CERS-NH plans are in good shape -- aren't they?

<u>NO. TRS and CERS-NH plans are NOT in good shape.</u>

Think of it this way…

- You have been making payments on your largest financial obligation – your home mortgage. (Or, for public employers, in this case, a pension obligation.)
- Payments are required well into the future, until fully paid.
- Ignoring the future, so far you have only paid less than 60% of what you should have paid.

What would you expect the mortgage company do?

The TRS and CERS-NH plans are in good shape -- aren't they?

<u>NO. TRS and CERS-NH plans are NOT in good shape.</u>

- Unfortunately, under any set of assumptions, the TRS and CERS-NH plans are NOT in good shape.

- Implementing the appropriate changes will require a <u>long-term (30 year) commitment</u> to reforms that are necessary to rebuild the foundation and that allows a path to fully sustainable fiscal health.

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PFM Group Consulting's Reports

#1 – Governance & Transparency

#2 – Historical & Current Assessment

#3 – Recommended Options

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The Pension Bill

Details!

What will change?

What will not change?

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KERS & CERS - Nonhazardous

- No reduction in cost of living adjustments (COLAs) for current retirees

  The amount of monthly pension checks will not change.

- No change to full retirement age

  This is the time at which an employee qualifies for full unreduced retirement benefits; it is not the time when an employee must retire.

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KERS & CERS - Nonhazardous

• Tier 1 employees will continue to accrue full unreduced retirement eligibility (27 years of service or age 65) within current defined benefit program

Tier 1 employees were hired prior to 9/1/2008

• Tier 2 employees will continue to accrue full unreduced retirement eligibility ("Rule of 87" or age 65) within current defined benefit program

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KERS & CERS - Nonhazardous

- Tier 1 and Tier 2 employees will move into a defined contribution plan after reaching the threshold service accrual for an unreduced retirement benefit (i.e. 27 years/Rule of 87)
- Tier 3 employee accounts will immediately roll over into the defined contribution program

    Tier 3 applies to those hired since 1/1/2014; they are now covered by the 4% Cash Balance plan

- All new hires will be enrolled in the defined contribution program

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KERS & CERS - Nonhazardous

• 3% of employee's salary as additional contribution to help prefund fund the retiree healthcare program

This funds post-retirement health benefits.

• Future retirees must suspend pension to accept full-time positions in the public sector for duration of their reemployment

KEEPING THE PROMISE

KERS & CERS – Nonhazardous

• Comp time payments included in the benefit calculation for any member retiring on or before July 1, 2023

This applies to the lump sum payment of unused comp time at the time of retirement; "block 50" payments will still be included in benefit calculations.

• Requires "High 5" to be a full 60 months of service.

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KERS & CERS – Nonhazardous

• Aligns upper limit of eligible compensation for benefit calculation with Social Security; uniform/equipment allowance is no longer included as creditable compensation

In 2018, the limit will be $128,700

• Caps unused sick leave to sick leave balance accrued on June 30, 2018.

• Sick leave credit no longer used to determine retirement <u>eligibility</u> effective for retirements on or after July 1, 2018.

Frozen sick leave will be included in the benefit calculations.

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The new Defined Contribution Plan – contribution rates	KERS/CERS SPRS/KJRS
Employee - mandatory	3%
Employer - mandatory	2%
Employee - optional	6%
Employer match	3%
	14%

KEEPING THE PROMISE

TRS – Teachers Retirement System

- No change to full retirement age

  This is the time at which an teacher qualifies for full unreduced retirement benefits; it is not the time when an teacher must retire.

- No Social Security coverage for current or future teachers

  Teachers have been exempt from Social Security taxes and benefits since the origination of the system in the 1930s. Teachers do receive federal Medicare benefits.

  Many teachers say they want to be in Social Security, but the organizations that represent them oppose Social Security coverage.

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TRS – Teachers Retirement System

• Defined benefit plan will remain open to current teachers/university members until they accrue full unreduced retirement eligibility (27 years of service or age 60)

• Current teachers who have met the threshold (i.e. 27 years) <u>on</u> July 1, 2018 will have the option (1) to continue to accrue service credit in the defined benefit plan for up to three additional years or (2) move into an enhanced Social Security replacement defined contribution plan. The defined contribution plan will be a generous defined contribution plan - 18% of their salary.

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TRS – Teachers Retirement System

• New teachers & those who meet the unreduced retirement threshold after July 1, 2018 will enroll in the generous defined contribution plan with the option to max out 18% of their salary.

• Current teachers/university members, with less than five years of service in the current defined benefit plan, will have the option to transfer to the defined contribution plan

• Future retirees must suspend pension to accept full-time positions in the public sector for duration of their reemployment

KEEPING THE PROMISE

TRS – Teachers' Retirement System

The new Defined Contribution Plan – Contribution rates	New Teachers & those 27+ year teachers <u>after</u> effective date	Teachers with 27+ years <u>on</u> July 1, 2018
Employee - mandatory	9%	10%
Employer - mandatory	4%	8%
School district - mandatory	2%	-
Employee - optional	3%	-
	18%	18%
Range	15% - 18%	18%

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TRS – Teachers' Retirement System

• Sick leave balances will be frozen as of July 1, 2018 for *university members* who receive service credit for accumulated unused sick leave

• School districts can continue to provide payment for up to 30% of a retiring member's accumulated sick leave and lump-sum payments for accumulated sick leave will be utilized in retirement benefit calculations for those retiring on or before July 1, 2023; after that date, payments for sick leave will not be utilized for benefit calculations.

Sick leave policies and cash payments for sick time will continue to be made according to local school board policy.

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TRS – Teachers' Retirement System

• Use of "High 3" for benefit calculation permitted for any member retiring before June 30, 2023; after June 30, 2023 a "High 5" will be utilized for benefit calculations

High 5 means that average of the highest 5 years (60 months) of compensation are used to compute pension benefits.

• 3% of employee's salary as additional contribution to fund the retiree post-retirement healthcare program

This funds post-retirement health benefits.

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TRS – Teachers' Retirement System

- No reduction in previously granted cost of living adjustments (COLAs) for current retirees; COLAs for current retirees temporarily suspended for five years; COLAs for future retirees will begin in the 6th year in retirement

The amount of current monthly pension checks will not change.

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KERS & CERS – Hazardous; SPRS

- Defined benefit and 4% cash balance plans remain open to current hazardous employees
- No change to full retirement age

  This is the time at which an employee qualifies for full unreduced retirement benefits; it is not the time an employee must retire.

KEEPING THE PROMISE

KERS & CERS – Hazardous; SPRS

• New employees will continue to enroll in current cash balance plan but may elect to be in the defined contribution plan

• Caps sick leave at the balance accrued on June 30, 2018. Sick leave credit no longer used to determine retirement <u>eligibility</u> effective for retirements on or after July 1, 2018

KEEPING THE PROMISE

KERS & CERS – Hazardous & SPRS

• Comp time for retirement compensation purposes will continue to be utilized for Tier 1 employees only; comp time for retirement compensation purposes is already not applicable to Tier 2 and Tier 3

• "High 3" will be a full 36 months of service

• Uniform/equipment allowance is no longer included as creditable compensation; KLEPFP payments continue to be included

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KERS & CERS – Hazardous & SPRS

• Reemployment after retirement will require both an employee and employer normal cost contribution to be paid to the system from which the employee retired; no second retirement account

Payment of normal cost does not apply to part-time employment

• 3% of employee's salary as additional contribution to fund retiree healthcare program

• Closes loophole to ensure payment of death benefits for the families of hazardous employees

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Legislative Retirement

• Defined benefit plan closed for those who already have unreduced pension benefit, moving them into the same defined contribution plan as other state employees under the jurisdiction of the KRS Board.

> *For those who have not earned an unreduced benefit as of June 30, 2018, their LRP account will be frozen and they will then be covered in KERS until they reach an unreduced benefit. That that time they will be covered in PERS.* Their DB benefits will be based only on their legislative earnings.

• Cash balance plan members will immediately roll over into the defined contribution program

• New legislators enroll in the defined contribution plan

KEEPING THE PROMISE

Legislative Retirement

- Existing defined benefit members and current retirees will have their benefit calculation based solely on their legislative salary

- 3% of employee's salary as additional contribution to fund retiree healthcare program

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Judicial Retirement

- Defined benefit plan remains open to current employees until accruing full unreduced retirement eligibility
- Members will move into a defined contribution plan after reaching threshold years of service
- Cash balance plan members will immediately roll over into defined contribution plan
- New members enroll in the defined contribution plan
- 3% of employee's salary as additional contribution to fund retiree healthcare program

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Additional Reforms

• Level dollar amortization replaces percent of payroll for ADC/ARC calculation for all systems

• Two-year window available for KRS and TRS outside agencies, non-profits and universities to pay full actuarial cost of promised benefits and cease participation in the retirement systems

• Legislative and judicial retirement systems (KJFRS) will be under jurisdiction of KRS Board

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Additional Reforms

• The effective date of the changes will be July 1, 2018. The pension bill will not have an emergency clause.

• Kentucky Public Employee's Deferred Compensation Authority (Ky Deferred Comp or KDC) will administer PERS – Public Employees Retirement System. KDC has been existence for many years and has over 75,000 members, including 25, 000 teachers.

• Statutory requirement to pay the ADC/ARC

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What happens if pension reform does not occur?

Pensions & the Budget

Investment Return Assumptions	2016 Assumptions			2017 Assumptions
	Underfunding amount (Millions)	Funded %	Investment Return	
KERS - Non-haz	$ 11,112.40	16.0%	6.75%	5.25%
KERS - Haz	377.20	59.7%	7.5%	6.25%
SPRS	540.60	30.3%	7.5%	5.25%
CERS - Non-haz	4,541.10	59.0%	7.5%	6.25%
CERS - Haz	1,565.30	57.7%	7.5%	6.25%
TRS	14,531.30	54.8%	7.5%	7.50%
KLRP	15.20	85.1%	7.0%	6.50%
KJREP	115.00	72.1%	7.0%	6.50%
	$ 32,798.10			

Pensions & the Budget

Percent of payroll	FY 2016 Assumptions	FY 2018 Preliminary Revised Assumptions	Percent Increase	Aggregate Additional Dollars Needed
KERS - Non-haz	50.39%	84.06%	66.68%	$ 221.30
KERS - Haz	21.82%	41.12%	88.45%	17.30
CERS - Non-haz	19.18%	28.86%	50.47%	325.20
CERS - Haz	31.55%	50.67%	60.62%	113.30
SPRS	89.67%	154.10%	71.85%	12.80
TRS	n/a	n/a	n/a	819.10
				$ 1,509.00

Pensions & the Budget

Fiscal needs – The General Fund

- The Budget Reserve Trust Fund (Rainy Day Fund) should be at least 5% of annual revenues – about $550 million.
- For FY 2019, the full ADC/ARC will be included in the budget – an additional $700 million more than in FY 2018.
- FY 2019 revenue growth will be modest.
- To be fiscally responsible, we need to free up an additional $1,000,000,000 – one billion dollars – per year.

Pensions & the Budget

Three Options

Reduce spending

Increase revenue

Reduce the cost of pensions

Pensions & the Budget

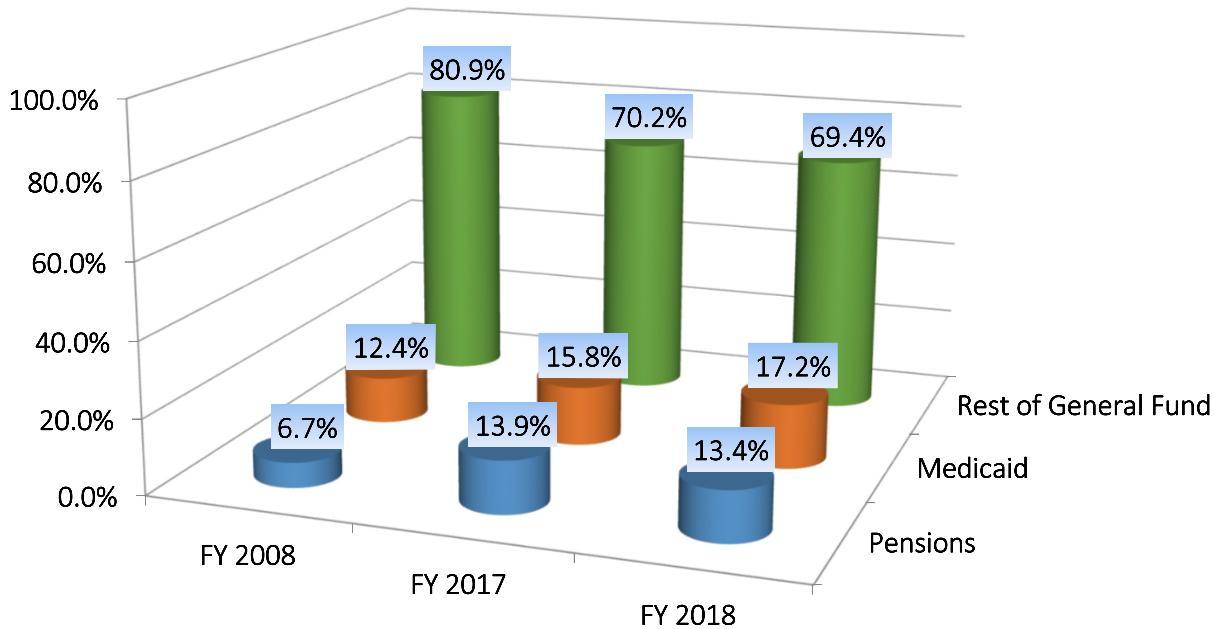
Reduced spending on government services

- In the last budget cycle, spending for many programs was reduced by 9%.

- Important government services were not subjected to cuts – K-12 education (SEEK), Medicaid, public protection, debt service, etc.

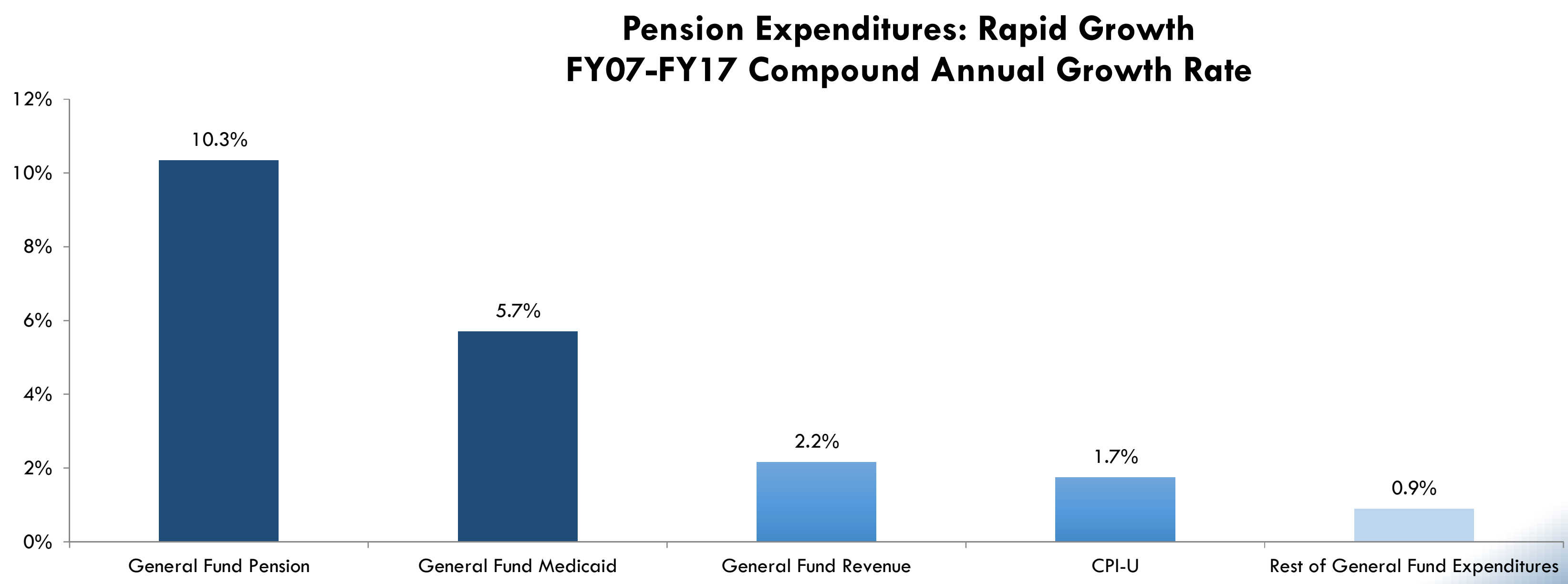
Pensions & the Budget

Pensions and Medicaid
a growing share of General Fund Spending



Pensions & the Budget

Pension Expenditures are Crowding out the Rest of the Budget and Growing Much Faster than Revenues



Pensions & the Budget

Raising $1 billion - the FY 2018 Budget

K-12 Education	$ 3,725	32.9%
Higher Education	1,173	10.4%
Medicaid	1,945	17.2%
Pensions	1,513	13.4%
All other	2,960	26.2%
	$ 11,316	100.0%

All other spending	$2,960,000,000
Spending reduction	1,000,000,000
Percent of all other spending	34%

Pensions & the Budget

Decrease spending on government services

- Protecting those same programs from cuts in FY 2019 would require that all other programs be cut by 34.4%

- Protecting those same programs but additionally subjecting education (SEEK) to cuts, requires cuts of 16.86%.

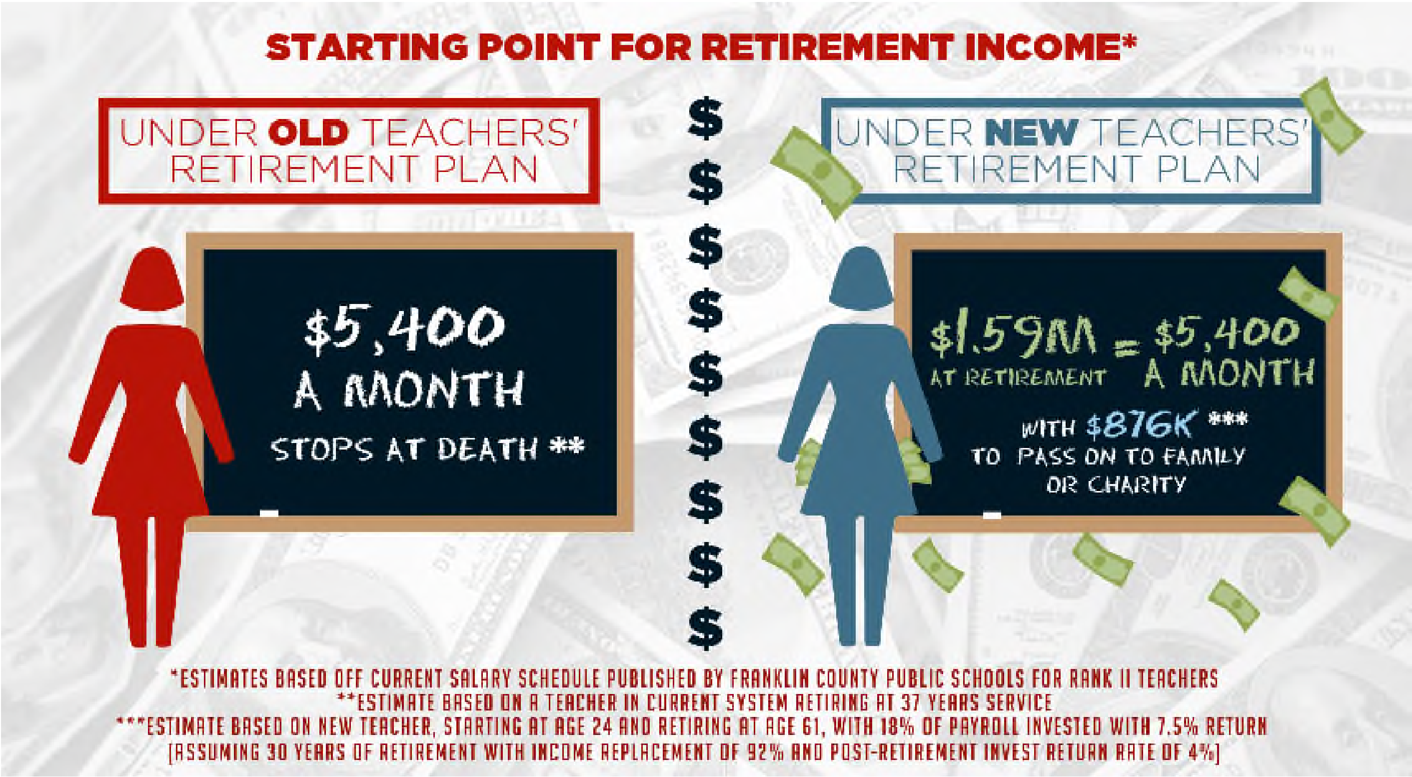
- SEEK would be reduced by $510 million (out of SEEK's $3.024 billion appropriation)

A Defined Contribution Plan is Valuable Asset

A Defined Contribution account is a valuable asset.

- With advice from professionals, employee controls investments and he/she can be as conservative or as aggressive as desirable.
- After vesting (5 years), the entire account is non-forfeitable and will continue to grow.
- Money can be withdrawn without IRS penalties as regular monthly amounts or as a lump-sum to satisfy unexpected needs or desires.
- When the employee dies, the account passes to family members or a charity.

A Defined Contribution Plan is Valuable Asset



A Defined Contribution Plan is Valuable Asset

Teacher starts employment	age 24
Teaching career	37 years
Age at retirement	61
Salary	$42,000, +1.4% inflation
Annual contribution	18%
Investment return	7.5% while working
Value of account after 27 years	$693,000
Value of account at retirement after 37 years	$1,590,000

A Defined Contribution Plan is Valuable Asset

Issues to be clarified

- Line of Duty death and disability benefits – retention of current benefits to be maintained
- Cost of post-retirement healthcare benefits
- Rehire provisions

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To Keep the Promise, we must act now!

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Questions?

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More information:

KentuckyPensions.com