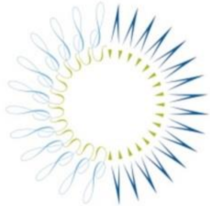

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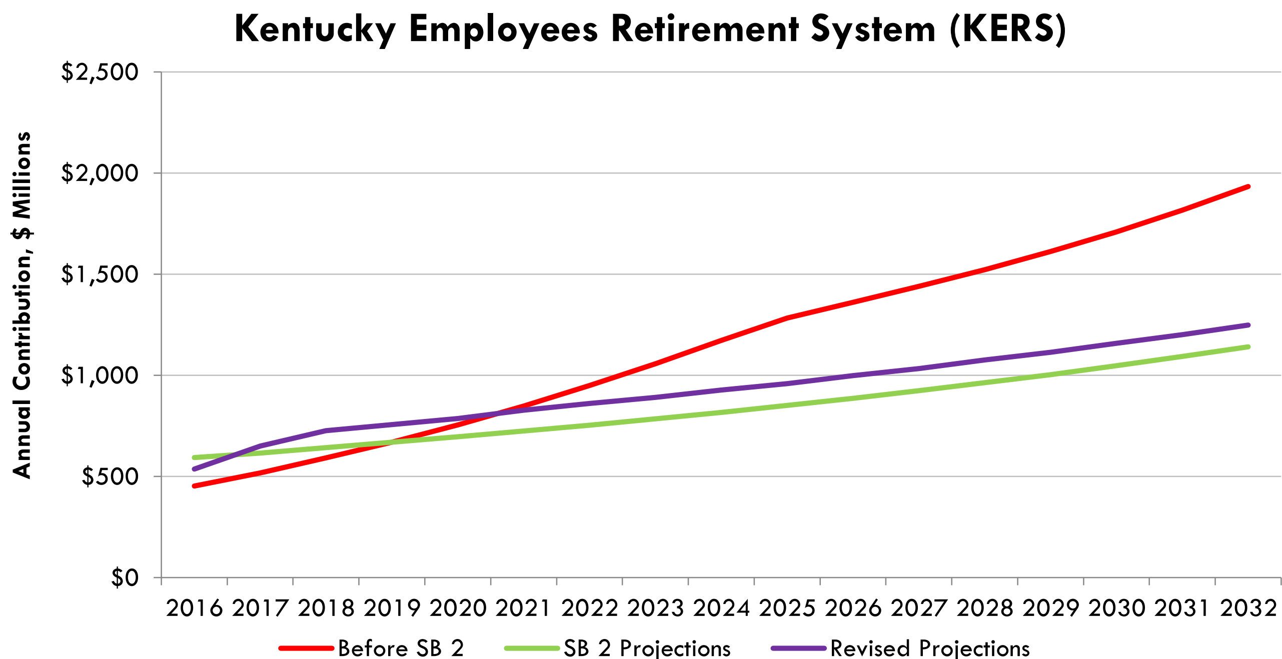
Staying the Course: An Updated Analysis of the Kentucky Retirement System

In 2013, the Kentucky legislature approved SB 2, with wide bipartisan support, as part of an effort to put the Kentucky Retirement System on a path to fiscal sustainability. The legislation included a commitment to fully funding the system going forward, limiting future cost-of-living adjustments, and adopting a new, portable cash-balance retirement savings plan for workers. The analysis and forward-looking projections done in 2013 indicated that the reforms implemented under SB 2 put Kentucky's retirement system on track to become fully funded while also providing workers with a secure retirement. We present the updated analysis below to show that Kentucky, in our view, is still on track to full funding provided the state continues to stay on the course charted in 2013.

KERS and CERS Remain on Track

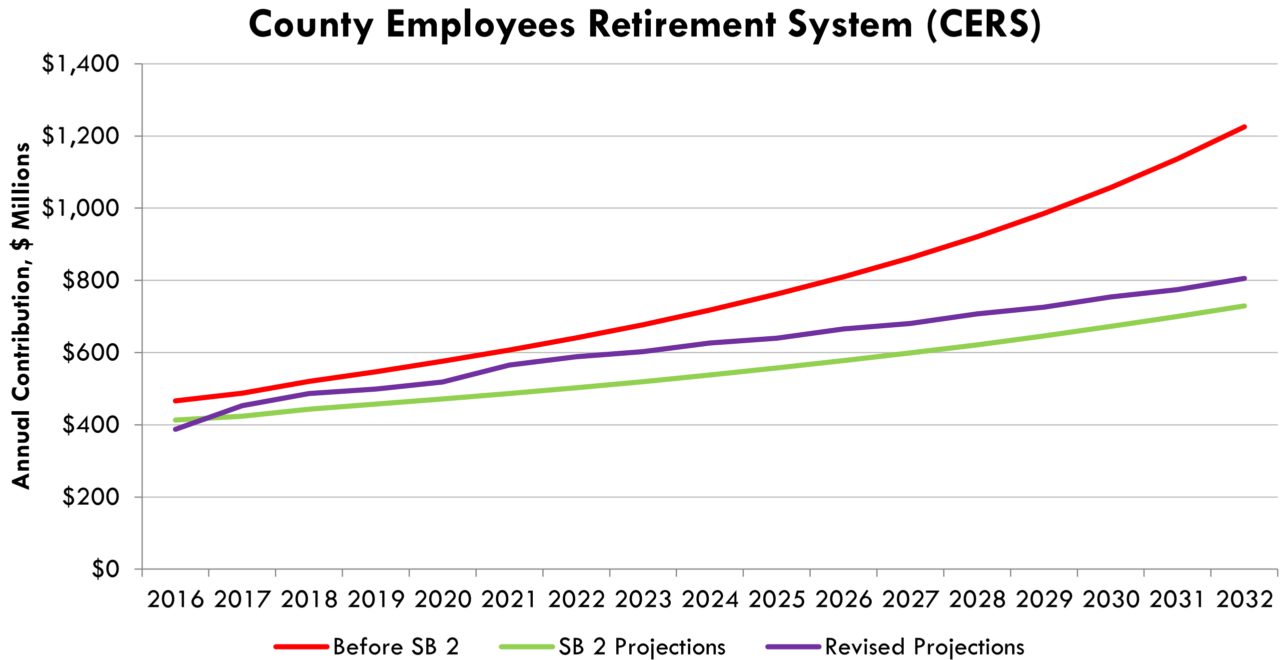
Figures 1 & 2 below show that annual contributions for both the Kentucky Employees Retirement System (KERS) and the County Employees Retirement System (CERS) closely track the initial projections completed back in 2013. The revised projections are based off of the 2016 actuarial valuation and do not include the most recent changes to assumptions (which will be discussed separately). Although costs are somewhat higher due to recent changes in the discount rate, lower than expected investment returns, and other economic factors, costs going forward are still expected to be on track with the original estimates for SB 2 and significantly lower than under the prior policy.

Figure 1*: Updated projections for KERS indicate significant cost reductions as a result of the 2013 reforms*



Note: Prior policy and SB 2 projections are from the 2013 actuarial report prepared by the plan actuary. Revised projections are calculated by an independent actuary based on the information released in the 2016 KRS actuarial valuation.

Figure 2: *Updated projections for CERS indicate significant cost reductions as a result of the 2013 reforms*



Note: Prior policy and SB 2 projections are from the 2013 actuarial report prepared by the plan actuary. Revised projections are calculated by an independent actuary based on the information released in the 2016 KRS actuarial valuation.

<u>Comments on Potential Changes to KRS in SB 226</u>

Although Pew takes no formal position on SB 226 (2017) or the full range of policy considerations associated with CERS becoming an independent system, we note that CERS is in a much stronger financial position than KERS and highlight several provisions of SB 226 that Pew research has identified as best practices. These provisions, enumerated below, would: (1) significantly improve the plan's ability to monitor its fiscal sustainability; (2) strengthen plan governance and board structure; (3) ensure policymakers have accurate information by requiring comprehensive fee disclosure; and (4) improve funding discipline.

(1) Requires an annual actuarial evaluation of the plan be completed which includes 20-year forward projections and sensitivity analysis.
Note: *Pew recommends stress testing and sensitivity analysis as a regular practice to help policymakers monitor the fiscal strength and sustainability of its pension funds.*

(2) Create a newly formed board of trustees that will take control of the CERS system from Kentucky Retirement Systems (KRS). The newly formed board would have nine members total, six of whom would be required to have either investment or retirement expertise.
Note: *Research shows that ensuring board members have relevant expertise helps in governance and decision-making. Pew does not have a position on creating a separate board for CERS.*

(3) The plan's Comprehensive Annual Financial Report (CAFR) should include comprehensive fee reporting consistent with Institutional Limited Partner Association (ILPA) standards.

Note: *Pew estimates that approximately $4 billion in fees go unreported by public pension plans across the 50 states on an annual basis.*

(4) Requires any change affecting plan finances be accompanied by 20-year forward-looking projections and any future cost-of-living adjustment must be fully funded before being granted. **Note**: *Pew research indicates that unfunded benefit increases can comprise a significant portion of a plan's unfunded pension liability, particularly in the long-term.*

Comments on Recent Recommendations

In late August, a consulting firm hired by the state released recommendations regarding potential changes to Kentucky retirement policy, including KRS. More recently, proposed legislation has been released based on those recommendations (17 SS Bill Request 10). We reviewed both to see how the changes would differ from the work done by the 2012 task force that led to the 2013 reforms contained in SB 2.

(1) Assumption Changes

The August recommendations included changes to the actuarial assumptions used to calculate the liability and the actuarial contribution rate for Kentucky's pensions. The KRS board has already made adjustments to actuarial assumptions consistent with the August recommendations. The assumed rate of return for KERS Non-Hazardous and State Police plans was dropped from 6.75% to 5.25% and for KERS Hazardous and both CERS plans from 7.5%to 6.25%. In addition, the KRS board adopted a payroll growth assumption of 0%, effectively switching to a level dollar contribution policy.

Adopting more conservative assumptions, as these changes do, would cost more in the short-term but save money in the long-term and add extra cash to an underfunded pension system. However, it will have an immediate impact on budgets—increasing pension contributions needed for KRS by over $800 million as a result of lowering the assumed rate of return and switching to level debt payments. Paying off KRS' pension debt faster will reduce long-term costs while requiring higher contributions in the short-term. The proposal would also reset the amortization period to a new 30-year schedule, delaying the time at which KERS and CERS are expected to be fully funded.

(2) Changes to Current Employee and Retiree Benefits.

The August recommendations contained substantial reductions in benefits for both current employees and retirees. The recent bill has not included most of those cuts. Instead, there are two significant changes to current plan participants. Existing employees in the Tier 3 hybrid cash balance plan would have their accrued benefit transferred to a new defined contribution account while current members in the final average salary defined benefit plan would have their benefit capped once they reach the full retirement age.

Changes to current member benefits were not included in SB 2.The 2012 task force discussed the possibility of current employee changes but the general understanding from Kentucky policymakers was that the contractual protections in Kentucky state law could prevent changes to current employees and retirees. Ultimately, courts would need to decide if any changes to current employees or retirees are permissible.

(3) Defined Contribution Plan for New Hires

The 2012 task force also considered a defined contribution (DC) plan for new hires as a way of making employer costs more stable, but ultimately settled on the hybrid cash balance plan design as a fair way to provide retirement security while sharing risk between employer and employees. The hybrid cash balance plan would protect taxpayers from approximately 40 percent of investment risk as well as reducing demographic risk in estimating the cost of retirement benefits. In designing the hybrid cash balance plan, policymakers kept the ability to change the guaranteed interest rate and the rules for sharing upside gains to ensure that the plan remains affordable and sustainable.

A well-designed DC plan can provide retirement security to participants; however, the base combined contribution rate from the recent recommendation is 5% of pay (2% from the employer and 3% from the employee). That is below minimum recommended amounts for savings from a DC plan of at least 12 percent combined contributions from the employer and employee. While employees who contribute more than the minimum contribution would get a 50 percent match, up to a combined contribution of 14 percent of pay, this would still leave many employees with insufficient retirement savings.

Conclusion

The changes made to KRS in SB 2 (2013) are working and are on track. The SB 2 reforms focused on improving the long-term fiscal health of KRS, leaving opportunities for further improvements on areas like governance and transparency. While Pew has no position on separating CERS from KRS, the provisions in SB 226 (2017) on stress testing, board expertise, fee disclosure, and cost estimates are best practices that should be considered for KRS. The recent recommendations, now represented in 17 SS Bill Request 10, would make major changes to KRS and Kentucky pension policy and the benefit changes proposed will likely require both a legal review and an evaluation of the impact on retirement security for workers.