Report of the Task Force on Kentucky Public Pensions

(2012 House Concurrent Resolution 162)

Research Memorandum No. 512

Legislative Research Commission
Frankfort, Kentucky

December 2012

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Report of the Task Force on Kentucky Public Pensions

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Legislative Research Commission
Frankfort, Kentucky
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Approved by the Task Force on Kentucky Public Pensions
December 7, 2012

Foreword

The Task Force on Kentucky Public Pensions was created in 2012 by House Concurrent Resolution 162. The task force was directed to study and develop consensus recommendations concerning the benefits, investments, and funding of the state-administered retirement systems, and any other measures that the task force believed would lead to the improved financial stability of the systems. Its work resulted in the policy recommendations reflected within this report.

The task force members would like to acknowledge the many stakeholders who provided valuable suggestions and comments to the task force as well as those who provided testimony and expert insight, including the Pew Center on the States and the Laura and John Arnold Foundation.

Robert Sherman
Director

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Summary

The 2012 General Assembly adopted House Concurrent Resolution 162, which created the Task Force on Kentucky Public Pensions. The task force was directed to study and develop consensus recommendations concerning the benefits, investments, and funding of the state-administered retirement systems, and any other measures that the task force believed would lead to the improved financial stability of the systems.

The task force met six times over a 5-month period and focused its efforts on evaluating the Kentucky Retirement Systems (KRS), which administers three separate retirement systems for state and local government employees and retirees. These retirement systems include the Kentucky Employees Retirement System (KERS), the County Employees Retirement System (CERS), and the State Police Retirement System (SPRS).

Beginning in July 2012, KRS administrative staff provided the task force with an overview of system benefits, investments, and funding. The July meetings also included testimony by the Pew Center on the States and the Laura and John Arnold Foundation, which provided task force members with national statistics on pension funds, pension reform options evaluated and adopted by other states, and factors that must be addressed in Kentucky's pension reform process. In August and in the meetings that followed, the task force heard testimony and recommendations from employee and employer groups, retiree organizations, and the public. At the September and October meetings, the task force heard recommendations from the Pew Center on the States and the Laura and John Arnold Foundation for addressing the funding issues facing Kentucky Retirement Systems. The task force used the testimony it received in developing recommendations.

At the November 20, 2012, meeting, the task force adopted recommended changes for KRS and the Judicial Form Retirement System (JFRS), which administers the plans provided to legislators and judges. Recommended changes included paying the actuarially required contribution beginning with the 2014-2015 fiscal year for KERS and SPRS, eliminating retiree cost-of-living adjustments for KRS and JFRS retirees and beneficiaries, and resetting the amortization period for calculating employer payments to finance unfunded liabilities for KERS, CERS, and SPRS. The task force also recommended adopting a hybrid cash balance plan for new participants in KERS, CERS, and SPRS on or after July 1, 2013. The hybrid cash balance plan provides an employee with an individual retirement account but with guaranteed investment returns, the option to annuitize the account balance upon retirement, and disability and death benefits similar to the existing defined benefit plan. New legislators and judges would also be required to participate in the hybrid cash balance plan through participation in KERS.

The task force recommended increasing the break in employment required before a KRS retiree can return to work with a KRS employer from 3 months to 2 years, except that hazardous-duty members returning to work in a full-time hazardous position will be required to have a break in employment of 1 year. The task force also made recommendations to amend the current structure of the KRS board to include more representation by local government employers, to require

employers to pay the actuarial costs of pay raises above 10 percent per year during the 5 years prior to an employee's retirement, and to require KRS to post additional information online.

Chapter 1

Overview of Kentucky Retirement Systems

Background

Most Kentucky public employees are provided retirement coverage through one of six state-administered retirement systems. These systems are defined benefit plans, which provide lifetime retirement benefits for the employee based on a formula established by state statute that does not vary with the level of contributions, investment performance, and other relevant factors. This differs from a defined contribution plan, like a 401(k), where the retirement benefits the employee will receive are based on the account balance accumulated at retirement and vary based on the contributions, investment performance, the employee's life span, and other relevant factors.

These state-administered retirement systems, along with Social Security benefits, if applicable, and other sources of retirement income, such as other retirement accounts and post-retirement employment, serve as the basis for providing income to Kentucky public employees during their retirement years.[1]

Composition of Kentucky Retirement Systems

State employees and many local government employees generally participate in one of the three retirement systems described below. These three systems are administered under one administrative agency known as the Kentucky Retirement Systems (KRS). In addition to administering pension benefits, KRS is also responsible for the administration of retiree health benefits for members of these systems as well as disability and death benefits.[2]

Kentucky Employees Retirement System

This system was established in 1956, and its membership includes employees of state government; nonteaching staff at regional state-supported universities such as Eastern Kentucky University; and employees of local health departments, regional mental health centers, and other quasi-state agencies. The Kentucky Employees Retirement System (KERS) includes both nonhazardous and hazardous-duty benefits and contribution structures. KERS is governed by

[1] Teachers participating in the Kentucky Teachers' Retirement System and some local government employees do not participate in Social Security. State employees and teachers, as well as many local government employees, are eligible to participate in voluntary defined contribution plans offered by the state through the Kentucky Deferred Compensation Authority, which includes a 401(k) plan and a 457 plan.
[2] The other state-administered pension plans include the Kentucky Teachers' Retirement System, the Judicial Retirement Plan, and the Legislators' Retirement Plan. The legislative and judicial plans are administered under one administrative agency known as the Judicial Form Retirement System. Administrators of these retirement plans are also responsible for the administration of retiree health benefits and disability/death benefits for their members.

Kentucky Revised Statutes 61.510 to 61.705 and Title 105 of the Kentucky Administrative Regulations.

County Employees Retirement System

This system was established in 1958, and its membership includes employees of city and county governments, police and firefighters, nonteaching staff of local boards of education, circuit clerks, local library employees, and other local government agency employees. The County Employees Retirement System (CERS) includes both nonhazardous and hazardous-duty benefits and contribution structures. CERS is governed by Kentucky Revised Statutes 78.510 to 78.852 and Title 105 of the Kentucky Administrative Regulations.

State Police Retirement System

This system was established in 1958, and its membership includes all uniformed state police officers. The State Police Retirement System (SPRS) is governed by Kentucky Revised Statutes 16.505 to 16.652 and Title 105 of the Kentucky Administrative Regulations.

Kentucky Retirement Systems Administration

As provided by statute, a nine-member board of trustees oversees the administration of KRS with five trustees being elected by the membership, three being appointed by the governor, and one being the secretary of the Personnel Cabinet. The five elected trustees are two trustees elected by the KERS membership, two elected by the CERS membership, and one elected by the SPRS membership. Of the three members appointed by the governor, two must have at least 10 years of investment experience as defined by statute and one must be knowledgeable about the effects of pensions on local governments. Elected and appointed trustees serve 4-year terms and may serve no more than three consecutive terms.[3]

The board annually elects a chair and vice chair, and appoints members to various committees of the board, including the investment committee, retiree health plan committee, disability appeals/administrative appeals committee, legislative and budget committee, human resources committee, and audit committee. The current composition of the board is provided in Table 1.1. A CERS elected trustee position is currently vacant due to the resignation of Robert Wilcher in May. The board appoints an executive director to oversee day-to-day operations and to staff the needs of the systems. The current interim executive director is Bill Thielen, and as of June 30, 2011, KRS consisted of 248 employees.

[3] Legislative changes in 2008 and 2012 set a three-term limit. Current trustees serving terms in excess of the updated term limits are allowed to complete their current terms of office.

Table 1.1
Members of the Kentucky Retirement Systems Board of Trustees

Member Name	Appointment/Election
Thomas Elliott, chair	Governor appointee
Daniel Bauer, vice chair	Governor appointee
Jennifer Elliott	Governor appointee
Bobby Henson	KERS elected trustee
Vince Lang	CERS elected trustee
Tim Longmeyer, secretary	Personnel Cabinet
Randy Overstreet	SPRS elected trustee
Susan Smith	KERS elected trustee
Vacant	CERS elected trustee

Source: Kentucky Retirement Systems

Kentucky Retirement Systems Employer and Employee Membership

As of June 30, 2011, 379 agencies participated in KERS and 1,402 agencies participated in CERS. For both systems, state statute defines the types of agencies that are eligible for participation, with final approval in the process being granted or denied by the KRS board. In the case of KERS, an executive order declaring the agency eligible for participation is required while CERS agencies must meet statutory definitions in order to participate (the board determines if the agency meets the definition).

Once an agency begins participating, all regular full-time employees hired after the agency's participation date are required to contribute in the systems. For KERS and CERS, the term "regular full-time" means an employee who averages 100 hours of work per month over a calendar or fiscal year, except that a school board employee is required to average 80 hours per month over the months represented by the days worked.[4] All regular full-time state police officers participate in SPRS. The number of employees (often referred to as active members), former employees with accounts but not retired (often referred to as inactive members), and retired members by system is provided in Table 1.2.

[4] Certain exceptions apply to the regular full-time requirement such as seasonal, temporary, and interim positions that are not subject to the participation requirements. However, statute limits the duration and frequency of use of these positions by agencies.

Table 1.2
Number of Active, Inactive, and Retired Members, by System

System	Active members	Inactive members	Retired members	Total
KERS nonhazardous	46,044	33,350	36,239	115,633
KERS hazardous	4,045	2,351	2,090	8,486
CERS nonhazardous	84,837	57,073	40,174	182,084
CERS hazardous	9,019	2,047	5,158	16,224
SPRS	949	204	1,019	2,172
Total	144,894	95,025	84,680	324,599

Source: June 30, 2011 Comprehensive Annual Financial Report.

Employees earn service credit for months and days worked in regular full-time positions. With the exception of school board employees, all employees earn 1 month of service credit in the systems for every month worked in a regular full-time position. School board employees working in regular full-time positions earn service credit based on their days worked, with 180 days worked in a regular full-time position equaling 12 months of service credit (less service credit is given for days worked less than 180).

Within KERS and CERS, there are both nonhazardous- and hazardous-duty benefit and contribution structures. For a job to be classified as hazardous duty, it must meet the definition and requirements established by state law, the employing agency must request hazardous-duty coverage for the position and agree to pay the higher employer contribution rates, and the KRS Board of Trustees must review and adopt the position as hazardous. In general, hazardous-duty positions in KERS and CERS primarily cover police, fire, emergency medical services, and corrections employees.

Retirement Eligibility

Employees must meet certain age or service credit requirements before they can retire and begin receiving benefits.[5] In KRS, the retirement eligibility requirements vary based on type of coverage (nonhazardous or hazardous) and the date the employee first began participating in the systems. Two columns are provided in Table 1.3, one showing the requirements to earn an unreduced benefit (no penalties) and one showing the requirements for a reduced benefit (penalties are based on how many years the employee is short of reaching an unreduced benefit).

[5] Most employees can also purchase different types of service credit, such as military service and federal service, and can use the purchased service to meet the service requirements for retirement eligibility. In addition, employees of KERS and SPRS agencies and many CERS agencies receive additional service credit for accumulated sick leave at retirement, which can also be used to meet the service requirements for retirement eligibility. New participants on or after August 1, 2004, cannot use most service purchases toward meeting retirement eligibility requirements, and new participants on or after September 1, 2008, are further restricted. In addition, sick leave service credit for new participants on or after September 1, 2008, cannot be used for determining retirement eligibility.

Table 1.3
KERS, CERS, and SPRS Retirement Eligibility Requirements

System	Unreduced benefit	Reduced benefit
KERS and CERS Nonhazardous	**Participating prior to Sept. 1, 2008** • Any age with at least 27 years of service; or • Age 65 with at least 4 years of service **Participating on or after Sept. 1, 2008** • Must meet rule of 87 (age + service = 87) and must be at least 57 years of age; or • Age 65 with at least 5 years of service	**Participating prior to Sept. 1, 2008** • Age 55 with at least 5 years of service; or • Any age with at least 25 years of service **Participating on or after Sept. 1, 2008** • Age 60 with at least 10 years of service Note: Reduction determined by actuary, 4.5 percent to 6.5 percent for each year short of unreduced benefit.
KERS and CERS Hazardous; SPRS	**Participating prior to Sept. 1, 2008** • Any age with at least 20 years of service; or • Age 55 with at least 5 years of service **Participating on or after 09/1/2008** • Any age with at least 25 years of service; or • Age 60 with at least 5 years of service	• Age 50 with at least 15 years of service Note: Reduction determined by actuary, 6.5 percent for each year short of unreduced benefit.

Source: Kentucky Retirement Systems.

System Benefits

Each system is designed to provide three types of benefits: a monthly retirement benefit for life based on the employee's salary and service (the pension benefit), health insurance benefits after retirement, and disability/death benefits. Information on each of these benefits is provided below and on the following pages.

Pension Benefits

Since these plans are defined benefits plans, benefits are paid based upon a formula established by statute, which is as follows:

Final Compensation X Benefit Factor X Years of Service Credit = Annual Benefit

Final Compensation: The average salary used for determining benefits at the time of retirement. Usually the average of the highest 3 or highest 5 years of salary.

Benefit Factor: A percentage based on the retirement plan, the type of service, and the timing of the member's service.

Years of Service Credit: Service earned for employment, purchased service credit, and service credit awarded for accumulated sick leave at retirement provided the agency participates in a sick leave program.

Table 1.4
Retirement Benefit Calculation for KERS and CERS Nonhazardous Employees Participating Prior to September 1, 2008

Final Compensation	Benefit Factor	Service Credit
• Average of highest 5 years of salary • Must contain at least 48 months of service • Includes lump-sum payments for compensatory time	KERS: • 1.97 percent; or • 2.00 percent for employees with 13 months service between January 1998 and January 1999. CERS: • 2.2 percent if participating prior to August 1, 2004; or • 2.0 percent if participating on or after August 1, 2004, but prior to September 1, 2008.	• Service earned for time worked in a regular full-time position • Purchased service • Service credit for accumulated sick leave at retirement

Note: For KERS nonhazardous participants, the retirement windows that provided a high-three final compensation calculation and a 2.2 percent benefit factor for employees who met certain age and service requirements expired January 1, 2009. The high-three window also applied to CERS nonhazardous members and expired January 1, 2009.
Source: Kentucky Retirement Systems.

Table 1.5
Retirement Benefit Calculation for KERS and CERS Nonhazardous Employees Participating On or After September 1, 2008

Final Compensation	Benefit Factor	Service Credit
• Average of the 5 complete fiscal years immediately preceding retirement • Must contain 60 months of service • All 5 years must contain 12 months service • Does not include lump-sum payments for compensatory time	Years of service — Factor 10 or less — 1.10% More than 10, but no more than 20 — 1.30 More than 20, but no more than 26 — 1.50 More than 26, but no more than 30 — 1.75 Additional years above 30 — 2.00 Note: the 2.00 benefit factor applies only to service above 30 years service credit.	• Service earned for time worked in a regular full-time position • Purchased service • Service credit for accumulated sick leave at retirement (limited to 12 months)

Source: Kentucky Retirement Systems

Table 1.6
Retirement Benefit Calculation for SPRS and KERS/CERS Hazardous Employees Participating Prior to September 1, 2008

Final Compensation	Benefit Factor	Service Credit
• Average of highest 3 years of salary • Must contain at least 24 months of service • Includes lump-sum payments for compensatory time	• KERS: 2.49 percent • CERS and SPRS: 2.50 percent	• Service earned for time worked in a regular full-time position • Purchased service • Service credit for accumulated sick leave at retirement

Source: Kentucky Retirement Systems.

Table 1.7
Retirement Benefit Calculation for SPRS and KERS/CERS Hazardous Employees Participating On or After September 1, 2008

Final Compensation	Benefit Factor		Service Credit
• Average of highest 3 complete fiscal years • Must contain 36 months • All 3 years must contain 12 months service • Does not include lump-sum payments for compensatory time	Years of service 10 or less More than 10, but no more than 20 More than 20, but less than 25 25 or more years	Factor 1.30% 1.50 2.25 2.50	• Service earned for time worked in a regular full-time position • Purchased service • Service credit for accumulated sick leave at retirement (limited to 12 months)

Source: Kentucky Retirement Systems.

In KERS and SPRS, all accumulated sick leave is converted to additional months of service credit for employees who began participating in these systems prior to September 1, 2008. For CERS, the agency may adopt a sick leave program and choose the amount of sick leave that can be converted. For new employees who begin participating in the systems on or after September 1, 2008, additional service credit allowed from the conversion of sick leave is limited to 12 months.

The annual benefit resulting from the calculations in Tables 1.4 to 1.7 is paid to the retiree in monthly installments. At retirement, a retiree may choose to take a reduced benefit to provide a monthly benefit to a beneficiary upon death, either for a period certain or for the life of the beneficiary.

The systems administered by KRS also provide for a statutory 1.5 percent annual increase to these monthly benefits after retirement, often referred to as the cost-of-living adjustment (COLA). The two COLAs that would have been awarded on July 1, 2012, and July 1, 2013, are suspended under the current provisions of the biennial budget.

Retiree Health Insurance Benefits

The systems also provide access to group rates and medical insurance for retired members, spouses, and dependents. Coverage for retirees not eligible for Medicare is provided through the Kentucky Employees Health Plan, the same health plan provided to state and school board employees. Coverage for Medicare eligible retirees is provided through a plan administered or contracted through the retirement systems, which then coordinates with Medicare for delivery of health benefits.

As provided by state statute, the systems also subsidize medical coverage for the retiree and in some cases for the dependents of the retiree, most often if the member retires with hazardous-duty service credit. In general, employees participating prior to July 1, 2003, receive a percentage of the premium paid upon retirement based upon their service credit, while employees who begin participating after that date receive a set dollar amount for each year of service credit. The tables below and on the following page provide details about the benefits for nonhazardous- and hazardous-duty members based upon their participation dates.

Table 1.8
Health Insurance Benefits for KERS and CERS Nonhazardous Employees Upon Retirement

Participation Date in Systems	Eligibility Requirements	Percent or Dollars of Premium Paid for the Retiree	
Before July 1, 2003	Must be eligible to retire	Years of Service at Retirement	% of Premium Paid for Retiree
		Less than 4	0%
		4, but less than 10	25
		10, but less than 15	50
		15, but less than 20	75
		20 or more	100
On or after July 1, 2003, but prior to September 1, 2008	Must be eligible to retire; must have at least 10 years of service	$10 per month paid toward the health premium for each year of earned service. Amount is adjusted by 1.5 percent annually from date of participation.	
On or after September 1, 2008	Must be eligible to retire; must have at least 15 years of service	$10 per month paid toward the health premium for each year of earned service. Amount is adjusted by 1.5 percent annually from date of participation.	

Source: Kentucky Retirement Systems

Since the 2005 plan year, nonhazardous retirees participating in the Kentucky Employees Health Plan have also received a partial subsidy for dependent coverage that has also been provided to state and school employees participating in the plan. This subsidy for KERS and CERS nonhazardous retirees is scheduled to end December 31, 2012, in accordance with action taken by the KRS Board of Trustees under the authority of House Bill 265 passed during the 2012 Regular Session.

Almost all service purchases made on or after August 1, 2004, do not count toward meeting the service requirements for various levels of retiree health benefits listed in Tables 1.8 and 1.9.

Table 1.9
Health Insurance Benefits for SPRS and KERS/CERS
Hazardous Employees Upon Retirement

<table>
<tr><th rowspan="2">Participation Date in Systems</th><th rowspan="2">Eligibility Requirements</th><th colspan="3">Percent or Dollars of Premium Paid for the Retiree and Dependents of the Retiree</th></tr>
<tr><th>Years of Service at Retirement</th><th>% of Premium Paid for Retiree</th><th>% of Premium Paid for Dependents</th></tr>
<tr><td rowspan="5">Before July 1, 2003</td><td rowspan="5">Must be eligible to retire</td><td>Less than 4</td><td>0%</td><td>0%</td></tr>
<tr><td>4, but less than 10</td><td>25</td><td>25</td></tr>
<tr><td>10, but less than 15</td><td>50</td><td>50</td></tr>
<tr><td>15, but less than 20</td><td>75</td><td>75</td></tr>
<tr><td>20 or more</td><td>100</td><td>100</td></tr>
<tr><td>On or after July 1, 2003, but prior to September 1, 2008</td><td>Must be eligible to retire; must have at least 10 years of service</td><td colspan="3">• $15 per month paid toward the health premium for each year of earned service.
• Upon death of the retiree, the surviving spouse receives $10 per month paid toward the health premium for each year of earned hazardous-duty service credit.
• Amounts are adjusted by 1.5 percent annually from date of participation.</td></tr>
<tr><td>On or after September 1, 2008</td><td>Must be eligible to retire; must have at least 15 years of service</td><td colspan="3">• $15 per month paid toward the health premium for each year of earned service.
• Upon death of the retiree, the surviving spouse receives $10 per month paid toward the health premium for each year of earned hazardous-duty service credit.
• Amounts are adjusted by 1.5 percent annually from date of participation.</td></tr>
</table>

Note: Percent/dollar amount paid on behalf of a hazardous-duty retiree's beneficiary is based solely upon the retiree's hazardous service at retirement.
Source: Kentucky Retirement Systems.

Disability and Death Benefits

Like most defined benefit plans, the systems provide benefits for those employees who become disabled or who die prior to retirement, including in the line of duty disability and death benefits. After retirement, the benefits left to the retiree's beneficiary vary based on the payment option selected at retirement. For example, retiring employees may select to provide a lifetime benefit to a surviving spouse upon their death by taking an actuarially reduced monthly benefit. In addition, the systems provide a $5,000 lump-sum death benefit for members who retire with at least 4 years of service. Benefits for disability and death before retirement are described in the following table.[6]

[6] Employees participating in all state-administered retirement systems are eligible for special benefits if they are disabled or killed in the line of duty.

Table 1.10
Disability and Death Before Retirement
Eligibility Requirements and Pension Benefit Calculation

System	Disability	Death Before Retirement
KERS nonhazardous and CERS nonhazardous	Eligibility requirement: Minimum 5 years service to apply for benefits and approval determined by systems under criteria established by state statute. Benefit calculation: • For employees participating before August 1, 2004, service used to calculate benefits is doubled but cannot exceed 25 years of service or age 65 (when additional service is added to their current age). Exception: employees with 25 years of service have their service increased to 27 years. • For employees participating on or after August 1, 2004, the employee receives the higher of the benefit calculated using actual service or 20 percent of the employee's final rate of pay.	Eligibility requirement: The beneficiary is eligible for a monthly benefit for life based upon service credit and final compensation accrued if at the time of death the employee was: • Eligible to retire • Less than age 55, was working at the time of death, and had at least 5 years of service • Less than age 55, was not working at the time of death, and had at least 12 years of service Benefit calculated using final compensation and actual service earned at the time of death. Penalties apply if the member was not eligible for an unreduced benefit at the time of death.
KERS hazardous, CERS hazardous, and SPRS	Minimum 5 years service to apply for benefits and approval determined by systems under criteria established by state statute. Benefit calculation: • For employees participating before August 1, 2004, service used to calculate benefits is doubled but cannot exceed 20 years of service or age 55 (when additional service is added to their current age). • For employees participating on or after August 1, 2004, the employee receives the higher of the benefit calculated using actual service or 25 percent of employee's final rate of pay.	Same as above

Source: Kentucky Retirement Systems.

Reemployment After Retirement

State statute places restrictions on retirees returning to work after retirement with a participating employer of the systems. As a result of House Bill 1, passed during the 2008 Special Session, the following restrictions and requirements are applicable to employees who retire and return to work on or after September 1, 2008:

- **Required Break in Employment.** The employee must have a 3-month break in employment before returning to any position with an employer participating in the systems, except that hazardous KERS or CERS and SPRS retirees who return to work in a full-time hazardous-duty position are required to observe only a 1-month break in employment. If the break is not observed, the employee's retirement is voided and all benefit payments issued in error shall be repaid to the systems. Both the employee and employer must certify that no prearranged agreement for the employee to return to work existed prior to the employee's retirement.

- **How it works for the employee.** Provided the break is observed, the employee can return to work and draw a pension but will not contribute to the systems or earn a second pension.

- **How it works for the employer.** If the employee has returned to work in a position that would have qualified for participation in the systems, the employer is required to pay contributions to the systems and to reimburse the systems for the cost of health insurance premiums paid by the systems for the retiree (not to exceed the cost of the single premium). If the employee takes health coverage through the employer and waives coverage with the systems, then no reimbursement is required.

Reciprocity

Members who have service in more than one retirement plan administered by the Commonwealth of Kentucky can combine service in the plans to determine eligibility for retirement and final compensation (years of highest salary). Each system will pay a benefit based on the amount of service in that system.

Taxation of Benefits

Federal Income Tax

Monthly benefits from all systems are subject to federal income tax. If a member made contributions with after-tax dollars (usually service purchases), then a portion of the monthly benefit at retirement will not be subject to federal income tax.

State Income Tax

All benefits attributable to service earned on or before December 31, 1997, are exempt from Kentucky income tax. The portion of the member's benefits earned January 1, 1998, and after is subject to Kentucky income tax. However, an annual pension exclusion of $41,110 applies to this portion and to other retirement income sources.

System Funding

As with any retirement plan, funding for system benefits and expenses is provided through three sources: employer contributions, employee contributions, and return on investment. Employee contributions are set by state statute and do not vary. The employer contribution rate varies annually as determined by the actuarial valuation completed by the retirement system. Employee and employer contributions include funding for retirement benefits, which are managed and invested in separate pension funds for each of the systems, and for retiree health benefits, which are managed and invested in separate health insurance funds for each of the systems.

Employee Contribution Rates

Nonhazardous employees participating in the systems prior to September 1, 2008, contribute 5 percent of their pay toward funding pension benefits, while nonhazardous employees participating in the systems on after September 1, 2008, contribute 6 percent of their pay, with the additional 1 percent going to fund retiree health benefits. Hazardous-duty employees participating in the systems prior to September 1, 2008, contribute 8 percent of their pay toward funding pension benefits, while hazardous-duty employees participating in the systems on after September 1, 2008, contribute 9 percent of their pay, with the additional 1 percent going to fund retiree health benefits.

Determining Employer Contribution Rates and the Financial Health of the Systems

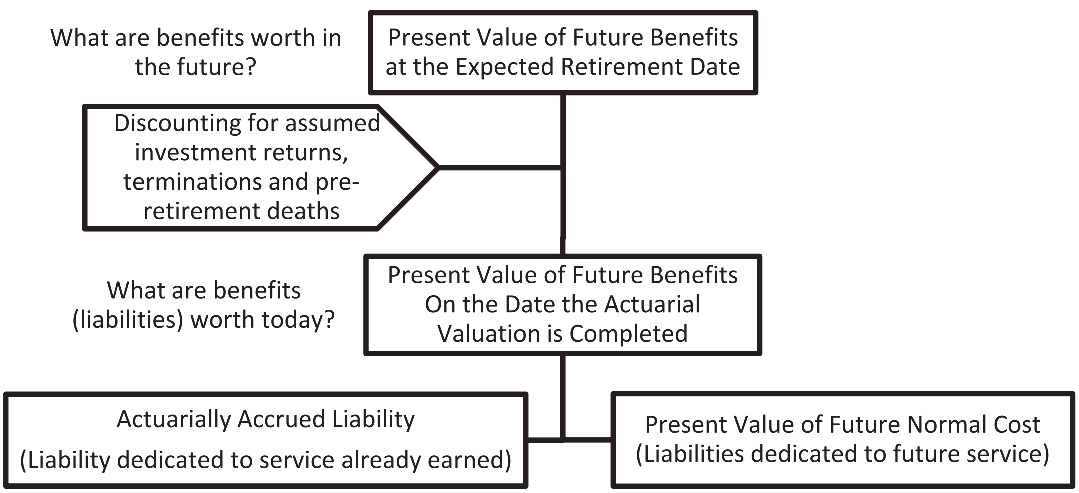
The retirement systems are required by statute to conduct an annual actuarial valuation of the plans. The purpose of the valuation, which is completed by an actuary hired by the systems, is to determine three main things:

1. **The amount of benefits (liabilities) to be paid out in the future.** To determine the employer contribution rates and to evaluate the financial health of each system, the actuary must first project the amount of benefits, or system liabilities, to be paid out in the future. These benefits are prescribed by law and regulation and, in some cases, the board of trustees. To calculate the amount of benefits that will be paid out in the future, the actuary must make assumptions about things that affect the system's money (the rate of return on investments, salary growth of employees, retiree medical inflation rates, etc.) and its people (when will people retire, how long will they live after retirement, etc.). Once these liabilities are determined, they are discounted to today's dollars and separated, using an actuarial cost method (the systems use the entry age normal cost method) into two components: the actuarially accrued liability (liability dedicated to service already earned by employees and

retirees) and the present value of future normal cost (liability dedicated to future service of employees based on assumptions). A graphic representation of this process is provided in Figure 1.A. From this calculation come the actuarial statistics to evaluate the system's actuarial health and the actuary's recommended employer contribution.

Some key assumptions in developing the liability values include the investment return and future medical inflation. For KRS, the investment return assumption is 7.75 percent per year for all pension and insurance funds except for the KERS nonhazardous and SPRS insurance funds, where the assumption is 4.5 percent per year. The medical inflation assumption is that premiums in the state health plan and the system's Medicare-eligible plans are anticipated to increase by 10.5 percent and 8.5 percent respectively in FY 2012, trending down annually until reaching a long-term annual increase of 5 percent in FY 2019 and beyond.

Figure 1.A
Process by Which the Actuary Determines System Liabilities



Source: Kentucky Retirement Systems.

2. **The financial health of the plan.** In the valuation, the actuary reports several statistics useful in evaluating the financial health of the plans as of the valuation date. The two most common actuarial statistics are the unfunded liability and the funding level, which compares the actuarially accrued liability (liability for benefits earned to date) against system assets. The unfunded liability is the dollar amount of the actuarially accrued liabilities that are not covered by system assets. The funding level is the percentage of the actuarially accrued liability covered by system assets. In calculating the unfunded liabilities and funding level as of the valuation date, the actuary uses a smoothed market value known as the actuarial value of assets, which smooths actual investment gains or losses over a 5-year period. Both of these statistics are affected by four main factors: the level of benefits payable in the future, the

Actuarial Value of Assets
<u>- Actuarially Accrued Liability</u>
= Unfunded Liabilities

Actuarial Value of Assets
<u>÷ Actuarially Accrued Liability</u>
= Funding Level

assumptions used by the systems' actuary (such as investment return, retirement rates), the systems' actual experience against those assumptions, and the level of funding made by the employer.

Funding levels and unfunded liabilities for each system's pension and health insurance funds are provided in Tables 1.11 to 1.14 as provided by the annual actuarial valuations conducted by the systems' actuary over that time frame. Since 2002, funding levels for each of the KERS, CERS, and SPRS pension funds have fallen significantly, while unfunded liablities have increased significantly for each fund. Over the same period, funding levels for the insurance funds have varied by system but have generally increased for CERS and KERS hazardous funds and fallen for KERS nonhazardous and SPRS funds. Unfunded liabilities for the health insurance funds increased until 2006 and have generally been decreasing across most systems since that time.

Table 1.11
Pension Funds Funding Level Over the Last 10 Years, by System

Valuation Year	KERS Nonhazardous	KERS Hazardous	CERS Nonhazardous	CERS Hazardous	SPRS
2002	110.4%	116.9%	129.6%	111.9%	115.3%
2003	97.4	108.1	119.7	97.8	99.6
2004	85.1	98.4	105.1	88.8	88.0
2005	73.6	92.3	94.0	80.9	77.1
2006	60.0	84.1	83.6	75.0	66.6
2007	56.9	83.6	82.1	74.2	63.7
2008	52.5	81.3	78.5	72.9	59.8
2009	45.0	74.5	71.4	67.9	54.8
2010	38.3	73.1	65.6	65.5	49.7
2011	33.3	70.8	63.1	62.2	45.0

Source: Kentucky Retirement Systems.

Table 1.12
Health Insurance Funds Funding Level Over the Last 10 Years, by System

Valuation Year	KERS Nonhazardous	KERS Hazardous	CERS Nonhazardous	CERS Hazardous	SPRS
2002	27.3%	57.4%	22.8%	30.0%	52.5%
2003	26.5	53.5	23.9	28.8	49.2
2004	25.7	52.3	24.0	30.3	48.9
2005	22.7	48.6	23.8	28.0	42.8
2006*	7.8	34.3	16.9	21.9	18.1
2007	11.9	49.8	28.8	31.2	26.6
2008	11.1	53.2	32.6	34.7	27.9
2009	11.9	61.4	39.6	40.9	33.9
2010	10.6	63.7	40.9	41.4	27.9
2011	10.6	65.1	46.6	46.8	28.2

*In 2006, the KRS board lowered the investment return assumption for the KERS nonhazardous and SPRS insurance funds, which resulted in a decrease in the funding levels for these funds.
Source: Kentucky Retirement Systems.

Table 1.13
Pension Funds Unfunded Liabilities Over the Last 10 Years, by System
(In billions)

Valuation Year	KERS Nonhazardous	KERS Hazardous	CERS Nonhazardous	CERS Hazardous	SPRS
2002	-$0.628	$0.054	-$1.232	-$0.158	-$0.058
2003	0.169	-0.029	-0.869	0.033	0.002
2004	1.050	0.006	-0.251	0.183	0.052
2005	2.000	0.034	0.326	0.343	0.105
2006	3.601	0.081	1.017	0.505	0.172
2007	4.089	0.092	1.192	0.569	0.199
2008	4.811	0.116	1.573	0.652	0.236
2009	5.864	0.172	2.262	0.827	0.272
2010	6.795	0.185	2.912	0.923	0.308
2011	7.455	0.211	3.288	1.079	0.349

Note: Negative values in 2002, 2003, and 2004 for a system reflect an actuarial surplus to those funds.
Source: Kentucky Retirement Systems.

Table 1.14
Health Insurance Funds Unfunded Liabilities Over the Last 10 Years, by System
(In billions)

Valuation Year	KERS Nonhazardous	KERS Hazardous	CERS Nonhazardous	CERS Hazardous	SPRS
2002	$1.386	$0.101	$1.527	$0.546	$0.079
2003	1.539	0.132	1.657	0.666	0.094
2004	1.735	0.154	1.853	0.715	0.101
2005	2.073	0.199	2.125	0.924	0.134
2006*	7.204	0.408	3.829	1.506	0.477
2007	4.580	0.253	2.374	1.134	0.318
2008	4.828	0.253	2.414	1.156	0.321
2009	3.973	0.189	1.854	0.942	0.241
2010	3.995	0.179	1.865	0.982	0.314
2011	3.828	0.177	1.641	0.877	0.315

*In 2006, the KRS board lowered the investment return assumption for the KERS nonhazardous and SPRS insurance funds, which resulted in an increase in unfunded liabilities for these funds.
Source: Kentucky Retirement Systems.

3. **The level of employer contributions:** The employer contribution for each of the systems includes two contributions: one to fund pension benefits and one to fund retiree health benefits. Each of these individual contributions comprises two components: a payment for normal cost (the estimated cost of the upcoming year of service for active employees) and a payment to finance the unfunded liability over a specific time period (26 years as of June 30, 2011). Employer contributions vary based on the level of unfunded liabilities and financial health of the individual system. As unfunded liabilities increase (or decrease), then employer contribution rates increase (or decrease).

   The actual employer contribution rates paid by KERS, CERS, and SPRS employers also vary based on the funding policies established by statute and by the board of trustees. Since FY 2003, the amount provided in the biennial budget for employer contributions to KERS and SPRS has been less than the amount recommended by the KRS board of trustees and its consulting actuary.[7] In 2008, the General Assembly established a funding policy to reach the full actuarially required contribution for pension and retiree health for KERS nonhazardous, KERS hazardous, and SPRS by 2025, 2019, and 2020, respectively. The policy, detailed in Table 1.15, requires an increasing percentage of the required contribution to be paid each year until the full actuarially required contribution is paid. For example, 53 percent of the actuarially required contribution of 44.55 percent for KERS nonhazardous in FY 2013 is 23.61 percent of payroll (the amounts required by the funding policy under the rates determined by KRS are included in the 2012-2014 biennial budget).

[7] Some rate reductions also occurred during a few years in the 1990s but were relatively minor in relation to the current rate reductions.

Table 1.15
House Bill 1 Phase-in Schedule for KERS and SPRS
Percent of the Actuarially Required Contribution To Be Paid, by Fiscal Year

Fiscal Year Ended	KERS Nonhazardous	KERS Hazardous	SPRS
2011	44%	76%	60%
2012	48	79	65
2013	53	83	70
2014	57	86	75
2015	61	89	80
2016	65	92	85
2017	69	95	90
2018	73	98	95
2019	77	100	98
2020	81		100
2021	85		
2022	89		
2023	93		
2024	97		
2025	100		

Source: KRS 61.565.

Since the late 1980s, the KRS Board of Trustees has established various funding policies to incrementally increase the employer contribution to fund retiree health benefits for all systems it administers, including CERS. In 2006, the board adopted a policy to phase in the full actuarially required employer contribution for retiree health benefits in CERS over a 5-year period (using FY 2008 as a base rate and increasing the rate over the 5-year period from FY 2009 through FY 2013). In the 2009 Regular Session, the General Assembly passed HB 117, requiring a 10-year phase-in period using the same start date and extending the phase-in period through FY 2018 for CERS.

The employer contribution rates for each system since FY 2002 is provided in Tables 1.16 to 1.20. These charts show the board-recommended pension and retiree health contribution (and the combined total) for employers in each system and the amount actually budgeted by the General Assembly (if applicable).[8] As can be seen from the tables, employer contribution rates have increased for all systems over this period as the unfunded liabilities have increased and as the funding policies have called for higher employer contributions.

[8] For FY 2009 and FY 2010, the board-recommended rate differs from the rate reported in the actuarial valuation (the actuarially recommended rate or ARC) for KERS nonhazardous and SPRS due to the investment return assumption used in the actuarial valuation versus the investment return assumption used by the board to determine the employer contribution rate.

Table 1.16
KERS Nonhazardous Employer Contribution Rates Since Fiscal Year 2002
As a Percentage of Payroll

Fiscal Year Ended	Board-recommended Employer Rate			Total Budgeted Rate
	Pension	Health Insurance	Total	
2002	0.00%	5.89%	5.89%	5.89%
2003	0.34	5.55	5.89	3.76
2004	2.86	4.67	7.53	5.89
2005	5.11	5.18	10.29	5.89
2006	7.85	5.77	13.62	5.89
2007	10.68	6.45	17.13	7.75
2008	15.55	32.82	48.37	8.50
2009	16.54	12.06	28.60	10.01
2010	18.96	12.33	31.29	11.61
2011	21.77	16.81	38.58	16.98
2012	24.30	16.41	40.71	19.82
2013	28.03	16.52	44.55	23.61

Source: Kentucky Retirement Systems.

Table 1.17
KERS Hazardous Employer Contribution Rates Since Fiscal Year 2002
As a Percentage of Payroll

Fiscal Year Ended	Board-recommended Employer Rate			Total Budgeted Rate
	Pension	Health Insurance	Total	
2002	6.18%	12.66%	18.84%	18.84%
2003	6.57	12.27	18.84	17.60
2004	7.37	11.47	18.84	18.84
2005	7.26	12.21	19.47	18.84
2006	8.52	13.07	21.59	18.84
2007	9.28	14.04	23.32	22.00
2008	10.20	36.91	47.11	24.25
2009	10.84	23.94	34.78	24.35
2010	11.98	23.56	35.54	24.69
2011	14.11	20.26	34.37	26.12
2012	14.11	19.73	33.84	28.98
2013	16.16	19.73	35.89	29.79

Source: Kentucky Retirement Systems.

Table 1.18
CERS Nonhazardous Employer Contribution Rates Since Fiscal Year 2002
As a Percentage of Payroll

Fiscal Year Ended	Pension	Health Insurance	Total
2002	0.27%	6.14%	6.41%
2003	0.66	5.68	6.34
2004	2.39	4.95	7.34
2005	2.82	5.66	8.48
2006	4.55	6.43	10.98
2007	5.97	7.22	13.19
2008	6.98	9.19	16.17
2009*	7.76	5.74	13.50
2010	8.62	7.54	16.16
2011	10.03	6.90	16.93
2012	11.70	7.26	18.96
2013	12.62	6.93	19.55

*The FY 2009 employer contribution rate for CERS nonhazardous was reduced from the amount recommended by the KRS board by HB 1 passed during the 2008 Special Session.
Source: Kentucky Retirement Systems.

Table 1.19
CERS Hazardous Employer Contribution Rates Since Fiscal Year 2002
As a Percentage of Payroll

Fiscal Year Ended	Pension	Health Insurance	Total
2002	3.06%	13.22%	16.28%
2003	4.67	11.61	16.28
2004	6.76	11.75	18.51
2005	9.31	12.77	22.08
2006	11.22	13.79	25.01
2007	13.11	15.10	28.21
2008	15.01	18.86	33.87
2009*	15.04	14.46	29.50
2010	16.11	16.86	32.97
2011	16.79	16.46	33.25
2012	17.91	17.85	35.76
2013	20.10	17.50	37.60

*The FY 2009 employer contribution rate for CERS hazardous was reduced from the amount recommended by the KRS board by HB 1 passed during the 2008 Special Session.
Source: Kentucky Retirement Systems.

Table 1.20
SPRS Employer Contribution Rates Since Fiscal Year 2002
As a Percentage of Payroll

Fiscal Year Ended	Board-recommended Employer Rate			Total Budgeted Rate
	Pension	Health Insurance	Total	
2002	0.00%	21.58%	21.58%	21.58%
2003	4.21	17.37	21.58	17.37
2004	2.64	18.94	21.58	21.58
2005	8.49	19.59	28.08	21.58
2006	14.49	20.34	34.83	21.58
2007	20.64	21.66	42.30	25.50
2008	28.95	91.05	120.00	28.00
2009	32.39	27.75	60.14	30.07
2010	35.23	26.64	61.87	33.08
2011	35.74	49.89	85.63	45.54
2012	39.80	54.83	94.63	52.13
2013	47.48	55.93	103.41	63.67

Source: Kentucky Retirement Systems.

Projected Employer Contribution Rates

Employer contribution rates for KERS, CERS, and SPRS are projected to continue growing due to several factors. For KERS and SPRS, increases will continue as a result of the HB 1 phase-in schedule to reach the full actuarially required contribution over time, automatic annual cost-of-living adjustments to retirees in the future that are not prefunded, and the unrecognized investment losses from prior years that will be smoothed into the employer rate over time. For CERS, increases in the employer rates will continue as a result of the current insurance phase-in to the full required contribution, automatic annual cost-of-living adjustments to retirees in the future that are not prefunded, and the unrecognized investment losses from prior years that will be smoothed into the employer rate over time. Employer rate projections for selected years are provided in the tables on the following page.

Table 1.21
KERS Projected Employer Contribution for Selected Years
As a Percentage of Payroll

Fiscal Year Ended	KERS Nonhazardous			KERS Hazardous		
	Pension	Health Insurance	Total	Pension	Health Insurance	Total
2013	14.86%	8.75%	23.61%	13.41%	16.38%	29.79%
2014	17.29	9.50	26.79	14.89	17.32	32.21
2016	21.47	10.93	32.40	15.92	17.81	33.73
2021	33.35	10.97	44.32	18.26	16.97	35.23
2026	44.11	10.62	54.73	20.03	14.30	34.33
2031	47.82	10.54	58.36	22.79	12.96	35.75

Source: Kentucky Retirement Systems.

Table 1.22
CERS Projected Employer Contribution for Selected Years
As a Percentage of Payroll

Fiscal Year Ended	CERS Nonhazardous			CERS Hazardous		
	Pension	Health Insurance	Total	Pension	Health Insurance	Total
2013	12.62%	6.93%	19.55%	20.10%	17.50%	37.60%
2014	13.39	7.38	20.77	21.78	18.70	40.48
2016	13.50	8.30	21.80	22.50	21.09	43.59
2021	14.18	7.83	22.01	25.18	21.31	46.49
2026	15.61	7.36	22.97	29.56	20.00	49.56
2031	17.82	7.15	24.97	35.57	19.63	55.20

Source: Kentucky Retirement Systems.

Table 1.23
SPRS Projected Employer Contribution for Selected Years
As a Percentage of Payroll

Fiscal Year Ended	Pension	Health Insurance	Total
2013	33.24%	30.43%	63.67%
2014	39.50	31.65	71.15
2016	49.10	31.29	80.39
2021	71.22	30.95	102.17
2026	85.05	30.71	115.76
2031	100.86	31.04	131.90

Source: Kentucky Retirement Systems.

Investments and Investment Performance

KRS invests system assets in separate pension and retiree health funds. Each fund invests in 13 asset classes as determined by the KRS Board of Trustees. These asset classes include fixed income, domestic equity, international equity, and newer asset classes such as private equity. Fund performance over the 1-, 3-, 5-, and 10-year periods for the fiscal year ended June 30, 2012, is provided in the table below. As can be seen from the table, the investment returns are less than the assumed 7.75 percent over this period.

Table 1.24
Kentucky Retirement Systems Investment Returns
as of June 30, 2012

	Pension Funds				Health Insurance Funds			
	1 year	3 year	5 year	10 year	1year	3 year	5 year	10 year
Total Fund	0.14%	11.30%	1.80%	5.99%	-1.71%	11.90%	-0.16%	5.86%
Benchmark	0.90	11.16	2.38	6.18	0.58	13.01	0.42	5.93

Source: Kentucky Retirement Systems.

Sources of Deterioration of Funding Levels/Growth in Unfunded Liabilities

A good deal of debate exists over the factors responsible for the deterioration in the systems' funding levels and the growth in unfunded liabilities in recent years. In 2011, the systems' actuary evaluated the factors that have led to the growth in higher unfunded liabilities from the June 30, 2005, actuarial valuation to the June 30, 2011, actuarial valuation for the systems respective pension funds. These factors include investment returns less than assumed; cost-of-living adjustments that were not prefunded; benefit increases; assumption changes; employer rate reductions for KERS and SPRS; demographic and salary experience, and other factors such as negative amortization of unfunded actuarial liability, data corrections, and software changes. The following table details these factors for each system.

Table 1.25
Factors Responsible for Unfunded Liability Growth From 2005 to 2011
for the KERS, CERS, and SPRS Pension Funds

Description	KERS Nonhazardous	KERS Hazardous	CERS Nonhazardous	CERS Hazardous	SPRS
Unfunded Liability as of 6/30/2005	**$2.000 billion**	**$0.034 billion**	**$0.326 billion**	**$0.343 billion**	**$0.105 billion**
Factor for Growth					
Investment Experience	+1.018	+0.065	+1.053	+0.331	+0.053
Employer Rate Reductions	+0.948	+0.012	Not applicable	Not applicable	+0.040
Cost-of-Living Adjustments	+0.995	+0.061	+0.528	+0.214	+0.064
Demographic and Salary Experience	+0.371	+0.030	+0.261	+0.061	+0.034
Assumption Changes	+0.690	+0.028	+0.357	+0.079	-0.038
Benefits	-0.088	-0.001	+0.072	+0.025	-0.019
Other	+1.345	-0.018	+0.692	+0.026	+0.111
Unfunded Liability as of 6/30/2011	**$7.455 billion**	**$0.211 billion**	**$3.288 billion**	**$1.079 billion**	**$0.349 billion**

Source: Kentucky Retirement Systems. Unfunded Actuarial Liability Attribution.

The values in the table above do not include investment experience, employer rate reductions, and other positive or negative actuarial experience that occurred prior to the June 30, 2005, actuarial valuation to the pension funds. They also do not include changes in unfunded liabilities to the health insurance funds for each system, including investment experience, employer rate reductions, or other positive or negative actuarial experience occurring in those funds. Budgeted reductions to the employer contribution occurring after June 30, 2011, are not included but will affect unfunded liability calculations in future actuarial valuations.[9]

[9] According to Kentucky Retirement Systems, for KERS and SPRS, the reductions in employer contributions to both pension and insurance funds total between $2.866 billion to $3.453 billion includes all past years' reductions and reductions not included in the unfunded liability calculation of the June 30, 2011, actuarial valuation that have occurred since that valuation.

Chapter 2

Testimony Before the Task Force

Several entities testified before the task force including staff from the Kentucky Retirement Systems, who provided an overview of the systems, and retirement stakeholders representing employees, retirees, employers, business groups, and the public who provided comments and recommendations for consideration. In addition, representatives from the Pew Center on the States and the Laura and John Arnold Foundation provided testimony throughout the task force proceedings on national and state pension issues and offered recommendations for consideration.

Kentucky Retirement Systems

At the July meetings of the task force, the executive director and chief investment officer for KRS provided an overview of the benefits, funding, and investments of the systems. Most of the information is covered in Chapter 1. KRS also provided the following information:

- **KRS plan are governed by federal law.** The three systems administered by KRS, the Kentucky Employees Retirement System, the County Employees Retirement System, and the State Police Retirement System, are qualified public defined benefit plans established under Section 401(a) of the Internal Revenue Code. This designation is necessary to allow pretax contributions to be made by the members.

- **There are different types of retirement plans provided to public- and private-sector employees.** A defined benefit plan pays guaranteed pension benefits based on a formula. At retirement, the final compensation of the member is multiplied by a "benefit factor" and the number of years of service. The product of this formula equals the annual benefit received by the member. The KRS plans are defined benefit plans.

  A defined contribution plan pays retirement benefits based on contributions and the investment earnings on those contributions, similar to a 401(k) plan. Fixed contributions are paid into an individual account by employers, employees, or both. Upon retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity, which then provides a regular stream of income. Use of defined contribution plans has become widespread in recent years, and they are now the dominant structure for retirement plans. Defined contribution plans are more portable than defined benefit plans and can move with employees as they change jobs over their careers. Investment risks and rewards are assumed by the employee and not by the employer. This risk could be substantial. For this plan type, the contribution is known, but the benefit is unknown until retirement occurs and the benefit is calculated.

  A hybrid plan contains aspects of both the defined benefit and defined contributions plans.

- **Changes in KRS membership statistics.** Between 2006 and 2011, the number of KRS members has increased by about 22,000, for a total of 324,599 members as of June 30, 2011.

The categories for retired members and inactive members have increased by about 11,000 each, while the category for active members has decreased slightly. The category of CERS nonhazardous members is the largest, with 182,084 members. KERS nonhazardous is the next largest category of members, with 115,633 members. Hazardous members, totaling 24,710, make up a relatively small part of the system.

- **System Assets.** As of June 30, 2011, KRS assets totaled approximately $14.77 billion. KRS pays $2 billion in pension and insurance benefits each year. Ninety-five percent of benefit payments is delivered to Kentucky residents.

- **Past legislative changes to KRS retiree health benefits**. Reforms to health insurance have moved the Commonwealth to a defined contribution system for health insurance for those hired after July 1, 2003. These actions have helped with the unfunded liability for the health portion of the retirement contribution.

- **KRS funding sources.** There are three sources of funding for the KRS: employee contributions, employer contributions, and return on investments. Employee contribution rates are set by statute, make up about 12 percent of the total funding in FY 11, and vary depending on the member classification and participation date. Employer contribution rates are recommended annually by the KRS Board of Trustees, are based on an independent actuarial valuation and recommendation, make up about 20 percent of the total funding in FY 11, and consist of a pension contribution and a health insurance contribution. The KRS Investment Committee makes investment decisions and hires external investment managers and consultants. Investment income makes up about 68 percent of the total funding in FY 11. Nationally, a lesser reliance is placed on investments with employees and employers funding more of those pension plans. From 1982 to 2009, total funding for public pensions plans nationally consists of investments making up about 58 percent, employer contributions making up about 28 percent, and employee contributions making up about 14 percent of the total funding.

- **Investment return experience.** KRS uses an investment return assumption of 7.75 percent. However, the actual amount of the 5-year, 10-year, and 15-year return has not met that assumption. The actuarial assumption of 7.75 percent used to project rates is also used to project the unfunded liability of the system.

  It is the goal of KRS to diversify assets as a protective method. When compared to the median numbers for a national public pension plan, those of KRS are close to the national averages.

  KRS assets are diversified throughout 13 asset classes. Target percentages of total assets are established for each asset class. KRS then monitors the asset classes to ensure proper diversification throughout the 13 classes. As of April 30, 2012, when considering the 1-year numbers related to investment returns and actual market benchmarks for those returns, most markets were performing well. It is noted that not every investment will work well at all times. Proper diversification controls the fluctuations among the asset classes. When comparing the annualized total fund return and the standard deviation for the last 5 years, the plan has underperformed by only 0.09 percent on the return basis. On a 10-year basis, KRS assets underperformed the median plan by only 0.28 percent. While assets earned slightly less than the median plan, less risk was encountered to earn that return.

- **Source of plan funding deterioration:** A significant cause of the increase in unfunded liabilities is the reduction in employer contribution rates in KERS and SPRS. The shortfall has been $2.866 billion over the last 20 years for both the pension and health insurance funds combined and is $3.543 billion if actual investment returns are included. Other causes include cost inflation for retiree health insurance; funding health insurance liabilities that were reported beginning in 2006 as a result of GASB 43/45; benefit enhancements; retiree COLA increases that were not prefunded; and market losses in 2000-2002 and 2008-2009. There have not been any significant benefit increases since 2001. According to the KRS actuary, the total increase in the unfunded liability from 2005 to 2011 in the KERS nonhazardous pension plan is attributed to investment loss (18.7 percent), COLA and benefits (19.8 percent), changes in actuarial assumptions (12.6 percent), employer contribution shortfall (17.4 percent), demographic and salary experience (6.8 percent), and "other" (24.7 percent—due partly to the closed amortization period).

Retirement Interest Groups and Organizations

During the August 21, 2012, meeting of the task force, testimony was received from 12 interested groups and organizations. Additional interest groups and organizations were heard during later meetings. Below is a synopsis of the recommendations made by each group or organization testifying.

Kentucky Association of Regional Mental Health/Mental Retardation Programs

Kentucky Association of Regional Mental Health/Mental Retardation Programs (KARP) was represented by its executive director. KARP is the association representing Kentucky's 14 community mental health centers, which were established by the General Assembly in 1966. KARP provided the following recommendations to the task force:

- The General Assembly should provide funding for community mental health centers to pay for increases in the KERS employer contribution rate in future budgets. In the 2010 Regular and Special Sessions, the General Assembly included approximately $2.5 million in FY 2011 and $3.8 million in FY 2012 to assist the community mental health centers in the current biennium. Additionally, language was included that the funding expansion could be used as a state match to draw down federal dollars through the Kentucky Medicaid Program, turning approximately $6.3 million into $21 million. Under this proposal, community mental health centers would pay a base rate, such as the first 15 percent of payroll, and all employer contributions greater than 15 percent would be funded in the biennial budget.
- Consider refinancing the current debt related to the unfunded liability through a bond issue.
- Permit the community mental health centers to offer an alternative defined contribution retirement plan to new hires. The executive director said this proposal would allow the community mental health centers to be treated the same way as the regional universities are

by the KRS and offer multiple retirement plans in addition to KERS while managing the cost of the employer contribution retirement.

Kentucky Chamber of Commerce

The Kentucky Chamber of Commerce was represented by its president and chief executive officer, who provided the following recommendations to the task force:

- Reduce health insurance costs in the state health plan administered by the Personnel Cabinet. The health benefits are set by the Personnel Cabinet annually, and the state has significant latitude to control costs by adjusting benefits. The unfunded liability can be significantly lowered by meaningful changes to health benefits for active employees, which affects the systems cost for retirees who also participate in the state health plan. Actions to control health insurance costs will not only have a positive impact on the retirement systems but will also reduce costs for active employees as well.
- Freeze cost-of-living adjustments. No COLAs should be provided to retirees until the system is more adequately funded.
- Establish a defined contribution plan. New employees should be placed in a defined contribution plan, and a portion of the employer contribution should be used to issue bonds to help finance the transition from the current defined benefit program. Financial incentives should be provided to current employees to convert to the new plan to help limit the unfunded liability.
- Amend KRS 61.650 to require the KRS Board of Trustees to consider the impact on the state budget of retirement benefit changes that they recommend or support.
- Eliminate double dipping. Public employees should be prohibited from retiring and then returning to full-time work in a similar job at the same agency.

Kentucky Association of Counties

Kentucky Association of Counties (KACo) was represented by the LaRue County judge/executive, who is the president-elect of KACo. KACo provided the following recommendations to the task force:

- Implement either a stacked hybrid plan or a cash balance system. Either of these options would adequately provide for future employees' retirement.
- Refinance the current debt related to the unfunded liability for CERS through a bond issue sufficient to increase funding levels to 80 percent in CERS.
- Freeze the current CERS employer rate. With a bond issue pushing the funding level to the 80 percent threshold, the balance of the employer contribution above the normal cost of the system could be used to pay the debt service for the bond. This would also give long-term rate consistency to struggling local governments.
- Lower the current retirement income exclusion for income tax purposes. Currently, the first $41,110 of all forms of retirement income is exempt. This provision should expire when the bond is retired.
- Separate CERS as a stand-alone governing board separate from the KRS Board of Trustees. Local governments have been consistent in paying 100 percent of the required contribution amount. CERS can reach the 80 percent funding threshold at a much faster rate than KERS. The viability of CERS is not anticipated to experience the cash flow problem currently

projected for KERS. KRS must make investment decisions on behalf of all five plans based on the cash flow needs of the most poorly funded program in the system. A separate board would be in a better position to adjust investment options to a more long-term, higher-yielding investment strategy.

Kentucky League of Cities

Kentucky League of Cities' (KLC) representative was the chief governmental affairs officer, who focused remarks on CERS. KLC provided the following recommendations to the task force:

- Change the cost-of-living adjustment for retirees. Eliminate COLAs or provide a payment option upon retirement that gives an annual COLA. COLAs could also be prefunded by increasing employee contributions.
- Implement an 80 percent funded ratio for full funding purposes. Many experts consider a funded ratio of 80 percent or better to be sound for government pensions.
- Make changes to reduce the unfunded liability in the health insurance trust by changing plans offered to active state employees, since retirees not eligible for Medicare receive paid coverage from the systems through this plan.
- Consider refinancing the current debt related to the unfunded liability through a bond issue. The General Assembly should explore whether rate stabilization would occur if an authority was created to bond the unfunded liability in CERS. Employer rates could be locked, and contributions above the normal costs could be used to pay debt service.
- Consider changes to the inviolable contract. Increase employee contribution rates for those employees who have not met the 5-year vesting requirement if needed for short-term employer rate relief.
- Create a new pension structure for new employees so that risk is limited or shared by employees and employers through a defined contribution plan, a hybrid plan with defined benefit and defined contribution components, or a cash balance plan.

Kentucky School Boards Association, Kentucky Association of School Superintendents, and Kentucky Association of School Administrators

The Kentucky School Boards Association, Kentucky Association of School Superintendents, and Kentucky Association of School Administrators, known as 3KT, were represented by the chief executive officer of the Ohio Valley Educational Cooperative and the director of governmental relations for the Kentucky School Boards Association. They provided the following recommendations to the task force:

- Suspend COLAs until they can be provided to retirees as a prefunded benefit. This change will help give employers in the system an opportunity to provide some long-term financial stability to CERS. Additionally, the change could allow for enough time for the system to achieve 80 percent actuarial funding.
- Find a solution to reduce health care costs.
- Consider a new pension structure for new employees. 3KT members do not fully support a 100 percent defined contribution plan for new employees.
- Complete a thorough analysis of the inviolable contract. This action would help provide a clear picture of changes that can be made for future retirees compared to changes that can be made to current employees and retirees.

Kentucky Professional Firefighters Association

The Kentucky Professional Firefighters Association was represented by its president and by the pension resources director for the International Association of Professional Firefighters. They provided the following recommendations to the task force:

- Conduct an experience study on plan assumptions and funding methods to get a clearer understanding of the unfunded liabilities.
- Consider refinancing the current debt related to the unfunded liability through a bond issue.
- Consider that the majority of firefighters in Kentucky do not have Social Security. Kentucky Retirement Systems is their principal source of retirement income.
- Project the effects of any benefit reductions.
- Evaluate legal issues regarding any changes. Kentucky has strong protections of contractual benefits for existing employees and retirees. Changes to benefits for existing employees are likely to face significant legal challenges.
- Provide consistent system funding, and consider the costs of closing a defined benefit plan.

Kentucky Association of Transportation Engineers and Kentucky Association of Transportation Employees

The Kentucky Association of Transportation Engineers (KATE) and the Kentucky Transportation Employees' Association (KTEA) were represented by the president of KTEA and the former president of KATE. They provided the following recommendations to the task force:

- Consider the retention of future employees in any changes. High-quality employees are critical to high-quality public services, and the pension system serves as a part of compensation to attract and retain qualified employees.
- KTEA and KATE do not support a full defined contribution plan for state employees. The pension system is part of compensation that helps attract employees, and employees are not professional money managers. If a defined contribution is pursued, it should include minimum mandatory employee and employer contributions and a guaranteed rate of return of 5 percent, and it should be professionally managed.
- Consider refinancing the current debt related to the unfunded liability through a bond issue. Much of today's problem has been caused by not investing into the retirement system; therefore, most of the solution needs to come with a major commitment to funding. Reforms made in 2008 will continue to have large effects.
- The state, as the employer, should pay the full actuarial required contributions that include the payment of prefunded cost-of-living adjustments to retirees.
- Any changes to the current pension system should include oversight of investment by KRS.
- Use money above projected receipts in the state budget from FY 2012 for pension funding and pay raises. The funds should be invested with one-half funding a possible 2 percent increase in salaries and one-half to supplement pension system funding.
- Offer a bonus for inactive retirement system participants to withdraw funds from the systems. This proposal lowers the liability for the system and affects approximately 29 percent of KERS membership.

American Federation of State, County, and Municipal Employees

The American Federation of State, County, and Municipal Employees (AFSCME) was represented by the executive director of AFSCME Council 62, the vice president of AFSCME International, and a labor economist with the AFSCME International Research Department. They offered the following recommendations to the task force:

- The full actuarial contribution must be made each year for all systems, including the intention to prefund COLAs. If a phase-in is necessary in the short run, it should be less than 12 years.
- Consider refinancing the current debt for the unfunded liability through a bond issue equal to the past dollar reductions to the employer contribution rate for KERS and SPRS. This proposal would improve funding ratios, decrease the costs of funding the debt, and eliminate future rating agency downgrades.
- Cut tax expenditures to fund debt service on any bond issue. Various tax expenditures could be eliminated and earmarked for this funding source.
- For CERS, instead of a specific contribution applicable to all employers (as a percentage of pay), require minimum contributions and allow individual employers to pay down their obligations more quickly, if they choose. With this option, the unfunded liability would have to be tracked by individual employers in CERS.
- Avoid CERS cost shifting. New accounting standards from the Governmental Accounting Standards Board will require that a pro rata share of CERS liabilities be reported on each participating agency's balance sheet. This may produce desire by CERS employers to exit the system and avoid paying their share of the liabilities. Policy makers may want to implement a withdrawal fee for any employer trying to exit the plan to discourage this activity. A complete review of exit and reentry rules is needed.
- Avoid the following actions: changing new hire benefits to a defined contribution plan or cash balance plan, modifying employee and retiree benefits that could result in a legal challenge, increasing employee contribution rates, offering employees varying benefit levels based upon employee choice, and reducing or eliminating the COLA.

Kentucky Public Retirees

The Kentucky Public Retirees was represented by its president and its vice president and liaison to Kentucky Retirement Systems. They offered the following recommendations:

- Consider refinancing the current debt for the unfunded liability through a bond issue.
- Require the full actuarial contribution each year for all systems. The underfunding in the budget process has been a significant factor in the unfunded KRS liability and also results in lower investment earnings.
- Prohibit future enhancement to retirement benefits without proper funding in the biennial budget.
- Close the remaining loopholes. Employees and retirees should not be allowed to change positions or be rehired in other positions in order to amass higher pensions.
- Maintain COLAs. The annual cost-of-living increases are important to keep up with the increasing cost of living as measured by the Consumer Price Index.
- Maintain retiree health insurance at current levels.

- Maintain fairness and equality among various retirees. Future legislative efforts should treat all retirees the same in the various state retirement systems.
- Any new pension structure should not draw attention and funds away from the current defined benefit plan.
- Maintain the inviolable contract. Any reform must protect the promised benefits offered through the inviolable contract.

Kentucky Education Association

The Kentucky Education Association represents both certified and classified personnel in local school districts. The association's assistant executive director and a classified member testified that they did not have specific recommendations to address the CERS unfunded liability but did encourage the task force to protect low-wage earners in the systems and to consider all reasonable measured options that fairly, though not necessarily equally, distribute the burden of solution among all the stakeholders.

Northern Kentucky Tea Party

A member of the Northern Kentucky Tea Party offered the following recommendations:
- The changes enacted by House Bill 299 in the 2005 Regular Session, that based legislative pension on the highest 3 years of salary rather than the highest 5 and that allowed the inclusion of salary earned in other public employment in this calculation, should be repealed retroactively.
- A 401(k)-style plan or a cash balance plan should be adopted for financial stability.
- Nonvested employees with less than 5 years of service should be transferred into the new system.
- Paid family health insurance coverage for hazardous-duty retirees and legislative retirees should be eliminated.
- Hire an independent panel to implement the reform.

Bluegrass Institute

The Bluegrass Institute's president and a local publisher offered several recommendations:
- Stop reemployment after retirement. The practice of double and triple dipping for all government workers, not just new hires, must end.
- Consider a new pension system. Move to a 401(k)-style plan where workers contribute more to their own retirement.
- Reform the current KRS Board of Trustees to include more members with financial expertise and to end dominance of the board by beneficiaries.
- End reciprocity provisions for lawmakers.
- Make the systems transparent by repealing the privacy provisions enacted in KRS 61.661. Other states have recently opened their pension data to the public for review.

Louisville Mayor; and Kenton, Campbell, and Warren County Judges/Executive

The mayor of Louisville Metro Government, the Kenton County judge/executive, the Campbell County judge/executive, and the Warren County judge/executive provided the following recommendations:

- Implement a cash balance plan or hybrid plan for new hires.
- Suspend COLAs for current retirees.
- Enact separate options for CERS and KERS by creating separate governance boards to administer the local retirement plan and the state retirement plan.
- Require current employees to pay more toward their current retirement by increasing employee contribution rates.
- State tax exemptions could be reduced or removed to increase the funding to the systems.
- Evaluate the use of pension bonds to fund the unfunded actuarial liability.

TIAA-CREF

TIAA-CREF was represented by its senior vice president for the Midwest Region, and head of National Government and Religious Markets. TIAA-CREF is a $500 billion nonprofit organization dedicated to government education and research and provides core defined contribution plan administration to many public entities including the University of Kentucky, the University of Louisville, Northern Kentucky University, and Kentucky's community colleges. TIAA-CREF made the following recommendations in the event a core defined contribution plan is adopted by Kentucky:

- Participation in the plan should be mandatory, with low age restrictions or none at all.
- The investment structure should consist of a limited low-cost investment menu with a maximum of 15 to 20 options preselected by the employer that include asset allocation vehicles such as target date or life cycle funds.
- Individual investment advice should be available at no cost to the participant.
- Annuities or other lifetime income options should be part of the distribution of assets.

Pew Center on the States and the Laura and John Arnold Foundation

The Pew Center on the States and the Laura and John Arnold Foundation offered their assistance to the task force and provided testimony at each of the task force meetings. Both organizations conduct pension-related research and have more recently become involved in providing assistance to state and local governments in developing pension reform. Their testimony to the task force included their perspective on Kentucky's pension issues, nationwide data on pension reform, and options and analysis for addressing Kentucky's pension issues. A summary of this information is provided on the following pages.

Perspective Regarding Kentucky's Pension Issues

The Pew Center on the States and the Laura and John Arnold Foundation evaluated Kentucky's public pension systems and offered the following observations and comments:

- **Kentucky is on an unsustainable course regarding its pension benefits.** In 2000, the state's pension systems had a $2 billion surplus. In 2011, they faced a $19 billion gap between what should have been set aside to pay for pension promises and what had been set aside. This problem might not be as threatening if the state were currently able to put money into the system to close the funding gap. Since 2003, nationally, public employers have not been able to make the full contributions that actuaries recommended to ensure that pension promises were funded.

- **How Did Kentucky Get Here?** The systems were fully funded in 2001, with a substantial surplus. A combination of increases in benefits, including cost-of-living adjustments that were not paid for when offered, investment losses from the 2001 recession, and the results of other major assumption performances being less that the system projected have created a funding gap. When the unfunded liability in the state plan increased, the actuarially recommended contributions went up, but the state did not appropriate the money needed to pay those increased contribution rates. From 2004 onward, the state's plans did not get enough in contributions from the state to keep them on a sustainable path. In 2007, the state's pension plans were only 68 percent funded and had a funding gap of more than $10 billion, even before the 2008 recession. The unfunded liabilities facing the state are the direct result of Kentucky's policy choices made over the past decade.

- **What has been done in Kentucky?** In 2008, the General Assembly passed pension reforms that rolled back some of the prior benefit increases for new employees participating on or after September 1, 2008, including reducing the benefit formula, increasing the retirement age, and requiring employees to contribute more toward their retiree health benefit. These changes will provide long-term savings, but because they only affect new employees, they will have a limited impact in the short term. Initial estimates suggest that these reforms will have saved the state a little more than $30 million in 2011; meanwhile the state fell short by about $300 million in employer contributions that same year.

- **Why is the cost so high to pay for Kentucky pension plans?** The annual cost for a pension system is made up of two things: a contribution to pay for the benefits earned that year (the normal cost) and a payment to close any existing funding gap (to pay off the unfunded liability). Looking toward the recommended contribution rates in 2013, the normal cost goes up just slightly, but the recommended rate to close the funding gap and to pay on the unfunded liability increases significantly. Kentucky ultimately is facing an annual retirement bill that is almost one-half of its payrolls. It is very costly for a state to rack up these unfunded liabilities because the bill eventually comes due. There is only so much to be done by cutting benefits for new workers; if those benefits were eliminated, closing the funding gap would still require a substantial infusion of money.

- **Kentucky is not alone in confronting these problems.** The 50 states faced an unfunded liability of $1.38 trillion in 2010 for similar reasons: insufficient contributions, retroactive benefit increases, and investment losses. While Kentucky was one of just four states (along with Connecticut, Illinois, and Rhode Island) that had funded less than 55 percent of pension obligations, Kentucky was one of just 10 states that are solid performers at managing retirees' health care benefits. Kentucky has made progress at setting money aside to pay for these promises and has taken steps to reduce its liabilities by requiring workers to contribute more and by increasing eligibility requirements.

- **What have policy makers learned?** The traditional defined benefit pension plan has structural problems that have helped lead to the substantial pension challenges facing the majority of the 50 states. State and local policy makers had the opportunity to skip payments and push the cost off to future taxpayers. These plans expose states to a variety of risks, particularly investment risk and longevity risk. Because traditional pensions concentrate their benefits on career employees, they may not reflect the modern workforce that a state needs and states may find that they miss out on younger workers who might expect to change jobs a number of times over their careers.

- **What can Kentucky policy makers do?** First, create a credible plan to close the funding gap, over time and in a fair way. This means putting more money into the system by making the full recommended contributions. Ultimately these promises will need to be paid, but it is important that states make these payments sustainably and over time. With severe unfunded liabilities, making these payments may be unaffordable and states may need to look for fair ways to share the sacrifice.

  Secondly, make sure the plan is sustainable and doesn't put the state at risk of future funding challenges. It is important that Kentucky find ways to make the plan sustainable, by ensuring that the state does not skip contributions, raise benefits without paying for them, or take on more risk than it can handle. In terms of managing the risk, this can include adjusting employee contribution rates based on funding levels, switching to hybrid plans or individual retirement accounts that shift risk to workers, or implementing plans in which benefits change based on the health of the pension system.

  Finally, it is important to ensure that the benefits being offered will help the state recruit and retain a talented public-sector workforce. Closing the funding gap cannot be achieved only by changing pension rules for new employees. There is not enough money, and such a policy would require draconian cuts. Kentucky should consider what kind of workforce it needs and what kinds of benefits would recruit and retain those workers.

National Perspective on Pension Reform

The Pew Center on the States and the Laura and John Arnold Foundation also discussed legislative measures enacted and proposed in other states regarding pension reform. Reform in other states has primarily focused on three areas:

- **Retiree cost-of-living adjustments**. Since 2010, 10 states have reduced cost-of-living adjustments to public employees and retirees as a way to address funding gaps.
- **Employee contribution rates**. Several states, including Alabama, Colorado, Kansas, Louisiana, Maryland, and New Jersey, have changed employee contribution rates to address funding gaps.
- **Benefit designs for current employees**. Several states have introduced plan design options including: 401(k)-style defined contribution plans such as the plan adopted in Alaska, hybrid plans that include both a traditional defined benefit plan and a defined contribution plan such as the plan recently adopted in Virginia, or cash balance plans that offer employees an

individual retirement account but include many of the protections commonly associated with defined benefit plans. Cash balance plans have recently been adopted in Kansas and Louisiana.

Some states have also evaluated the potential to limiting future retirement benefit accruals by current employees in addition to other reforms. In November 2011, Rhode Island passed major reforms that reduced its unfunded liability by an estimated $3 billion. The reforms had two major components. First, the state put employees, including current workers, in a hybrid pension plan that offered a smaller defined benefit plan supplemented by a defined contribution plan. Workers will still get all the pension benefits they have already earned but will get new benefits at a reduced rate. Second, the state substantially reduced the COLA given to retirees, including current retirees. The COLA will return when the state's pensions are at least 80 percent funded.

Options Evaluated To Close the Funding Gap

To address the pension funding gap, the Pew Center on the States and the Laura and John Arnold Foundation evaluated and recommended that several options be considered in developing a pension reform package. These options, along with a summary of their comments, are as follows:

- **Change the employer contribution phase-in schedule for KERS and SPRS.** The current phase-in schedule does not reach the full actuarially required contribution until 2025, 2019, and 2020 for the KERS nonhazardous, KERS hazardous, and SPRS plans, respectively. For every year Kentucky delays making the full contribution toward pensions, the eventual cost increases. Making the full required contribution starting in 2014 is the optimum funding policy. If immediate payment of the full contribution is unattainable, the task force should consider shortening the ramp-up to 4 or 6 years.

- **Reset the amortization period for financing unfunded liabilities.** The amortization period to finance the unfunded liabilities for the systems could be reset to a new 30-year amortization period. This action would provide immediate employer rate relief by reducing employer costs to finance unfunded liabilities but would increase costs in the long run by requiring additional years of employer payments for the unfunded liability.

- **Repeal the annual cost-of-living adjustment provisions.** The unfunded liabilities and employer contribution rates for KRS do not include COLAs for retirees. The presumption of an annual COLA should be removed from Kentucky statutes, in lieu of the legislature having to suspend it every year. The task force could consider giving employees the opportunity to purchase COLAs by voluntarily increasing their plan contributions or accepting a reduced retirement benefit.

- **Issue bonds and provide the proceeds to the systems.** The KERS nonhazardous plan is only 33.3 percent funded. Assuming the plan hits its investment target and employer contributions increase under the current phase-in schedule, the plan is projected to have less than 1 year of benefit payments in assets on hand by 2020. KRS has identified a ratio of assets to annual benefit payments of 1.1 as a key solvency threshold. Issuing $780 million in bonds and putting the funds into the KERS nonhazardous plan would keep that plan above the threshold, even under a projected pessimistic scenario. Bonds can also be used to refinance the systems' unfunded liabilities. It would take $4.2 billion in bonds to increase the funding levels of the systems to 66 percent, with a little more than $4 billion going into KERS and CERS and the remainder to SPRS, the Legislators' Retirement Plan, and the Judicial Retirement Plan. At the estimated 6.2 percent borrowing rate on a taxable pension bond, bonding may save money if KRS earns its assumed rate of return of 7.75 percent on the bond proceeds. If the systems investment return falls to 6.25 percent, money still would be saved but would not mitigate substantial risk to the state by issuing bonds. The potential savings to the state of bonding a larger amount to refinance unfunded liabilities is highly dependent on the bonding interest rate.

- **Increase employee contribution rates.** The contribution rate paid by employees could be increased by 2 percent, with 1 percent being used to fund pension benefits and 1 percent being used to fund retiree health benefits. Increasing employee contribution rates could raise concerns under the inviolable contract provisions.

- **Tax retirement benefits, and use revenue to pay down the unfunded liability.** Retirement income below $41,110 and public pension benefits related to service credit earned prior to 1998 are exempt from Kentucky income tax. The combined value of this tax credit in 2011 was estimated at $330 million. Lowering the exclusion to $25,000, while keeping the exclusion for public benefits earned before 1998, is estimated to bring in $50 million initially in FY 2014, with that figure growing each year. Eliminating the tax exclusion, but keeping benefits earned before 1998 untaxed, would bring in $160 million. If the exclusion were lowered to $25,000 but benefits earned before 1998 became taxable, the initial revenue gain is estimated to be $220 million. These additional revenues could be used to pay down the unfunded liability of the systems. However, the task force would also need to consider the legal issues involved relative to taxing benefits earned before 1998 if these options are considered.

- **Other items.** The task force should also consider ending reciprocity provisions for legislators in the Legislators' Retirement Plan if legislators are not required to go into the new-hire plan proposals; extending the waiting period before a KRS retiree can return to work with a KRS-covered employer to 2 years; requiring the employer to pay the actuarial costs of salary increases greater than 10 percent during the final 5 years of an employee's service; finding ways to increase representation of cities and counties on the KRS Board of Trustees; and requiring KRS to provide a link on its website that makes funding information and other useful data more directly available.

Packages of Options To Close the Funding Gap

Based upon the options evaluated, the Pew Center on the States and the Laura and John Arnold Foundation provided three packages of options as possible solutions for Kentucky to address the funding gap facing Kentucky.

The first package included the following options:

- Changing the employer contribution phase-in schedule for KERS and SPRS by ramping up employer contribution rates over 4 years in order to make full actuarially required contributions for these systems by FY 2017.
- Resetting the amortization period for KERS, CERS, and SPRS to pay off the unfunded liability by 2044.
- Issuing a $780 million bond to help address cash flow concerns for the KERS nonhazardous pension plan.
- Increasing employee contributions in KERS, CERS, and SPRS by 2 percent for those hired before 2008 (1 percent to fund pension benefits and 1 percent to fund retiree health benefits), and by 1 percent for those hired after 2008 (1 percent to fund pension benefits).
- Reducing the $41,110 tax exclusion on pension benefits to $25,000 and tax pension benefits earned before January 1, 1998.
- Eliminating automatic COLAs to KERS, CERS, and SPRS retirees and beneficiaries.
- Implementing the other items recommended including changes to reemployment after retirement, employer payments for salary increases during the employee’s final 5 years of service, and governance.

The second package was similar to the first, with two key differences: the amortization schedule is not reset, and the ramp-up to full actuarially required contribution for KERS and SPRS occurs over 6 years rather than 4.

The third package did not include bonding or tax pension benefits earned before January 1, 1998. To compensate, this option called for an immediate payment of the full actuarially required contribution rate for KERS and SPRS and eliminating the $41,110 tax exclusion for all retirement income. It resets the amortization period, increases employee contributions, eliminates COLAs, and addresses double dipping and governance changes the same as in the other two packages.

Retirement Benefits Proposed for New Employees

The Pew Center on the States and the Laura and John Arnold Foundation provided two options in developing a retirement plan for new employees:

- **Hybrid Cash Balance Plan.** In a cash balance plan, employee benefits are accounted for in individual retirement accounts into which both the employee and employer contribute. Benefits received upon retirement are based on what is in the account at the date of retirement. The employer guarantees a minimum return. When actual returns exceed that minimum amount, the employer keeps a portion of the excess and uses it to make up for down years. This plan will share risk among workers and also allow that risk to be shared with the employers, instead of requiring the employee to bear all the investment risk. The plan will offer an annuity option to employees upon retirement. The annuity is based on how much is in the employee’s retirement account at retirement. Currently, Nebraska and Texas offer this plan type, and Kansas and Louisiana have recently implemented this plan type for new workers.

Under the proposed hybrid cash balance plan recommended by the Pew Center on the States and the Laura and John Arnold Foundation, nonhazardous employees will contribute 5 percent of pay each year, while an employer credit of 4 percent of pay would also be deposited to the employee's account. Hazardous-duty employees will contribute 8 percent of pay each year, and the employer credit would be 7.5 percent of pay in the employee's account. Gains and losses will be shared between employees and the employers. Employees will get a guaranteed 4 percent annual return. If actual returns exceed that, employees will get 75 percent of the excess returns, while the remaining 25 percent will be placed in trust for the plan to pay for the guarantee in times when economic factors produce less than the guarantee.

- **Hybrid Defined Benefit/Defined Contribution Plan**. Under the hybrid defined benefit/defined contribution plan, employees would receive a smaller defined benefit based on their final compensation. Employees also receive an individual retirement account. The combination of the defined benefit and the individual retirement account offers workers their final benefit at retirement. Employees get a guaranteed benefit, but the state takes on less risk than with a traditional defined benefit plan. Employees who switch careers obtain more retirement benefits than those with a traditional pension plan.

  Under the proposed hybrid plan recommended by the Pew Center on the States and the Laura and John Arnold Foundation, nonhazardous employees will receive a defined benefit pension that matches 1 percent of final compensation per year of service. Final compensation will be based on the last 5 years of employment. In addition, each employee will receive an individual retirement account that has 3 percent of pay deposited into it annually and also grows through investment returns. Hazardous-duty employees will receive a defined benefit pension that matches 1 percent of final compensation per year of service. In addition, each employee will have an individual retirement account that has 7.5 percent of pay deposited into it annually and also grows through investment returns. Retirement ages will be the same as in the current plan for nonhazardous- and hazardous-duty employees.

Chapter 3

Task Force Recommendations

The Task Force on Kentucky Public Pensions adopted recommendations at its November 20 meeting for Kentucky's state-administered retirement systems.

The task force recommended the General Assembly take the following action regarding the Kentucky Employees Retirement System, the County Employees Retirement System, and the State Police Retirement System:

- Pay the full actuarially required contribution for KERS and SPRS beginning in FY 2015.
- Reset the amortization period for financing the unfunded liability for KERS, CERS, and SPRS to a new 30-year period.
- Repeal the cost-of-living adjustment provisions for KERS, CERS, and SPRS employees and retirees.
- Increase the required break in employment before returning to work after retirement to 2 years for retirees reemployed in a nonhazardous position on or after July 1, 2013. For hazardous-duty retirees reemployed in a full-time hazardous-duty position after that date, the recommendation is to increase the break in employment to 1 year.
- Require the employer to pay the full actuarial costs for annual salary increases above 10 percent that occur during an employee's last 5 years of employment prior to retirement.
- Change the composition and size of the KRS Board of Trustees as provided in Table 3.1.

Table 3.1
Kentucky Retirement Systems Board Composition Recommendation

Current Board Structure	Recommended Board Structure
Nine-member board: • Five elected (two from KERS, two from CERS, and one from SPRS) • Three appointed by the governor, of which two must have 10 years of "investment experience" as defined by statute and one must be knowledgeable about the impact of pensions on local governments • The secretary of the Personnel Cabinet	Eleven-member board: • Five elected (two from KERS, two from CERS, and one from SPRS) • Five appointed by the governor, of which two must have 10 years of "investment experience" as defined by statute and who cannot be employed or retired from KERS, CERS, or SPRS; one appointed by the governor from a list of three individuals recommended by the Kentucky League of Cities; one appointed by the governor from a list of three individuals recommended by the Kentucky Association of Counties; and one appointed by the governor from a list of three individuals recommended by the Kentucky School Board Association • The secretary of the Personnel Cabinet

- Require KRS to establish a webpage with information that is easily available and understood by the public regarding its financial and actuarial condition
- Establish a hybrid cash balance plan for new participants in KERS, CERS, and SPRS effective July 1, 2013, as provided in Tables 3.2 and 3.3 below.

Table 3.2
Hybrid Cash Balance Plan Recommended for New KERS and CERS Nonhazardous Participants Effective July 1, 2013

Provision	Recommended Hybrid Cash Balance Plan for Nonhazardous Participants
Plan administration	Kentucky Retirement Systems
Employee contribution	5% to pension 1% to retiree health 6% total
Employer contribution	Varies annually as determined by the actuary and as set by funding policies
Benefit	Employee accounts include an employee contribution of 5 percent of pay, employer credits of 4 percent of pay, and a guaranteed 4 percent investment return. These accounts also receive 75 percent of investment returns above 4 percent. Upon retirement, employees would be able to purchase an annuity based on the value of their accounts. The annuity would be based on the current mortality and investment assumptions used by KRS.
Retirement age/service	Same as current pension plans administered by KRS but no provision to retire under a reduced benefit
COLA	No COLA
Disability/death benefits	Same as current pension plans administered by KRS
Retiree health benefits	Same as current pension plans administered by KRS
Inviolable contract	Accrued benefits would remain protected, but the General Assembly could change prospective benefits if fiscal circumstances call for it.
Portability	Employee contributions and investment returns on those contributions are vested immediately. Employer credits and investment returns on those contributions are vested after 5 years (no vesting for these contributions until after the 5 years). Vested employees can withdraw their account as a lump sum (including employer credits, employee contributions, and investment return) or leave account with state to access benefits upon retirement.
Investment responsibility	Kentucky Retirement Systems

Table 3.3
Retirement Plan Design Recommendations for New SPRS and KERS/CERS Hazardous Participants Effective July 1, 2013

Provision	Recommended Hybrid Cash Balance Plan for Hazardous Participants
Administration	Kentucky Retirement Systems
Employee contribution	8% to pension 1% to retiree health 9% total
Employer contribution	Varies annually as determined by the actuary and as set by funding policies.
Benefit	Employee accounts include an employee contribution of 8 percent of pay, employer credits of 7.5 percent of pay and a guaranteed 4 percent investment return. These accounts also receive 75 percent of investment returns above 4 percent. Upon retirement, employees would be able to purchase an annuity based on the value of their accounts. The annuity would be based on the current mortality and investment assumptions used by KRS.
Retirement age/service	Same as current pension plans administered by KRS but no provision to retire under a reduced benefit.
COLA	No COLA
Disability/death benefits	Same as current pension plans administered by KRS
Retiree health benefits	Same as current pension plans administered by KRS
Inviolable contract	Accrued benefits would remain protected, but the General Assembly could change prospective benefits if fiscal circumstances call for it.
Portability	Employee contributions and investment returns on those contributions are vested immediately. Employer credits and investment returns on those contributions are vested after 5 years (no vesting for these contributions until after the 5 years). Vested employees can withdraw their account as a lump sum (including employer credits, employee contributions, and investment return) or leave account with state to access benefits upon retirement.
Investment responsibility	Kentucky Retirement Systems

The task force recommended the General Assembly take the following action regarding the Legislators' Retirement Plan (LRP) and the Judicial Retirement Plan (JRP):

- Repeal the cost-of-living adjustment provisions for JRP and LRP employees and retirees.
- Legislators and judges taking office on or after July 1, 2013, would participate in KERS under the new hybrid cash balance plan.