Public Pension Oversight Board

Research Memorandum No. 518

Legislative Research Commission
Frankfort, Kentucky

December 2014

Public Pension Oversight Board

2014 Report

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Approved by the Public Pension Oversight Board
December 15, 2014

Foreword

The 2013 General Assembly passed Senate Bill 2 that established the Public Pension Oversight Board. The purpose of the board is to review, analyze, and provide oversight to the General Assembly on the benefits, administration, investments, funding, laws and administrative regulations, and legislation pertaining to the Kentucky Retirement Systems. Its work resulted in the policy recommendations reflected within this report.

The board co-chairs would like to thank the board members; all those who attended the board meetings; and those who provided research, testimony, and input to the board.

Marcia Ford Seiler
Acting Director

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Summary

The 2013 General Assembly passed Senate Bill 2 that established the Public Pension Oversight Board. The purpose of the board is to review, analyze, and provide oversight to the General Assembly on the benefits, administration, investments, funding, laws and administrative regulations, and legislation pertaining to the Kentucky Retirement Systems (KRS). KRS consists of the Kentucky Employees Retirement System (KERS), the County Employees Retirement System (CERS), and the State Police Retirement System (SPRS).

The oversight board met 10 times in 2014, and the material covered included overviews of KRS benefits and funding; the two semi-annual investment reviews required by statute; updates on KRS agency participation issues including current litigation and legislative measures and options relative to this subject; a review of KRS trustee election issues and costs; a review of national trends regarding retirement board composition and elections; a review of Governmental Accounting Standards Board statements #67 and #68; information regarding the 2014 actuarial experience study and testimony from the KRS actuary; testimony on recommendations from employee, retiree, and other interested groups; and the results and data from the 2014 actuarial valuation and financial audits. A summary of the benefits, funding, investments, and testimony before the Public Pension Oversight Board are provided in Chapters 1 to 3 of this publication.

At the November 24th, 2014, meeting, the board adopted legislative recommendations for the 2015 Regular Session of the General Assembly. The board also adopted administrative recommendations for KRS and the Governor, and adopted specific study topics to be reviewed by the Public Pension Oversight Board in 2015.

Legislative recommendations from the oversight board included the following:
1) KRS housekeeping measures introduced in the prior session should be enacted;
2) Measures to address pension "spiking" should be enacted;
3) Legislation to include other state-administered retirement systems under the jurisdiction of the Public Pension Oversight Board should be enacted;
4) Legislation to require the state-administered retirement systems to conduct an actuarial experience study every five years should be enacted;
5) Additional funding to ensure solvency of the KERS nonhazardous pension fund should be secured by the General Assembly;
6) Legislation to address KRS agency participation issues should be enacted; and
7) Legislation to require KRS to incorporate sensitivity analysis into the annual actuarial valuation should be enacted.

Additionally, the Public Pension Oversight Board supports measures that provide additional funding to improve the financial health of KRS and in particular the KERS nonhazardous pension fund.

Administrative recommendations included the following for KRS:

- KRS should hire a separate actuary to perform an actuarial audit of the assumptions and funding methods used in the actuarial valuation and report the findings to the KRS Board of Trustees and the Public Pension Oversight Board;
- Relative to the actuarial experience study, KRS should consider the results of the actuarial audit, evaluate system cash flow needs, and move quickly on adoption; and
- KRS should take more action to electronically publicize KRS board meetings.

The Public Pension Oversight Board also recommended that the governor should include the actuarially required contribution rate for KERS and SPRS in the preparation of the next biennial budget. Finally, the Public Pension Oversight Board recommended that in 2015 the board should study cash flow issues facing the systems; KRS administrative expenses and comparisons against national trends; investment oversight/structure of other public pension funds; the personnel and compensation system of KRS; and KRS investment fees, expenses, and disclosures relative to other public pension funds.

Chapter 1

Overview Of Kentucky Retirement Systems Administration And Benefits

Composition Of Kentucky Retirement Systems

Most Kentucky public employees are provided retirement coverage through one of six state-administered retirement systems. The Public Pension Oversight Board has oversight responsibilities for the three systems administered by Kentucky Retirement Systems (KRS).

Kentucky Employees Retirement System

The Kentucky Employees Retirement System (KERS) 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. KERS includes both nonhazardous and hazardous-duty benefits and contribution structures. It is governed by Kentucky Revised Statutes 61.510 to 61.705 and Title 105 of the Kentucky Administrative Regulations.

County Employees Retirement System

The County Employees Retirement System (CERS) 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. CERS includes both nonhazardous and hazardous-duty benefits and contribution structures. It is governed by Kentucky Revised Statutes 78.510 to 78.852 and Title 105 of the Kentucky Administrative Regulations.

State Police Retirement System

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

These retirement systems, along with Social Security benefits, if applicable, and other sources of retirement income, such as other retirement accounts and postretirement employment, serve as the basis for providing income to state and local public employees during their retirement years.

Kentucky Retirement Systems Administration

As provided by statute, a 13-member board of trustees oversees the administration of KRS, with 6 trustees being elected by the membership, 6 being appointed by the governor, and 1 being the secretary of the Personnel Cabinet. The six elected trustees are two trustees elected by the KERS membership, three elected by the CERS membership, and one elected by the SPRS membership. Of the six members appointed by the governor, two must have at least 10 years of investment experience as defined by statute, one must be knowledgeable about the effects of pensions on local governments, and three are selected from lists submitted by the Kentucky League of Cities, the Kentucky Association of Counties, and the Kentucky School Boards Association. Elected and appointed trustees serve 4-year terms and may serve no more than three consecutive terms.

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 below.[1] The board appoints an executive director to oversee day-to-day operations and to staff the needs of the systems. The current executive director is Bill Thielen, and as of June 30, 2014, KRS consisted of 258 employees.

Table 1.1
Members Of The Kentucky Retirement Systems Board Of Trustees
As Of December 2014

Member Name	Appointment/Election
Thomas K. Elliott, chair	Governor appointee
Dr. Daniel Bauer, vice chair	Governor appointee
Mike Cherry	Governor appointee
J.T. Fulkerson	Governor appointee, KLC
Joseph Hardesty	Governor appointee, KSBA
Randy K. Stevens	Governor appointee, KACo
Vince Lang	KERS elected trustee
Mary Helen Peter	KERS elected trustee
Edwin Davis	CERS elected trustee
David Rich	CERS elected trustee
William Summers	CERS elected trustee
Randy Overstreet	SPRS elected trustee
Tim Longmeyer	Personnel Cabinet Secretary

Note: KLC is the Kentucky League of Cities, KSBA is the Kentucky School Boards Association, and KACo is the Kentucky Association of Counties.
Source: Kentucky Retirement Systems

[1] Senate Bill 2, passed during the 2013 Regular Session, increased the KRS Board of Trustees membership from 9 to 13 members by adding one CERS elected trustee and the three trustees appointed by the Governor from lists submitted by the Kentucky Association of Counties, Kentucky League of Cities, and Kentucky School Boards Association.

Kentucky Retirement Systems Employer And Employee Membership

As of June 30, 2014, 354 agencies participated in KERS and 1,137 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, the agency is not allowed to discontinue participation, and all regular full-time employees hired after the agency's participation date are required to contribute to 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.[2] 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.

Table 1.2
Number Of Active, Inactive, And Retired Members, by System
As Of June 30, 2014

System	Active Members	Inactive Members	Retired Members	Total
KERS nonhazardous	40,500	41,213	38,022	119,735
KERS hazardous	4,094	3,318	2,467	9,879
CERS nonhazardous	82,494	70,231	46,112	198,837
CERS hazardous	9,189	2,038	6,066	17,293
SPRS	861	239	1,279	2,379
Total	**137,138**	**117,039**	**93,946**	**348,123**

Source: June 30, 2014, KRS Annual Audit.

KRS Employee Participation Requirements

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 fewer than 180).

[2] 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.

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. In KRS, the retirement eligibility requirements vary based on type of coverage (nonhazardous or hazardous-duty) and the date the employee first began participating in the systems. Table 1.3 shows eligibility requirements for nonhazardous employees, and Table 1.4 shows eligibility requirements for hazardous-duty employees. Both tables show the requirements to earn an unreduced benefit (no penalties) and the requirements for a reduced benefit (penalties are actuarially determined and based on how many years the employee is short of reaching an unreduced benefit).

Table 1.3
Retirement Eligibility Requirements For Kentucky Employees Retirement System/ County Employees Retirement System Nonhazardous Members

Participation Date	Unreduced Benefit	Reduced Benefit
Prior to Sept. 1, 2008	• Any age with at least 27 years of service or • Age 65 with at least 4 years of service	• 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 but prior to Jan. 1, 2014	• 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	• Age 60 with at least 10 years of service
Participating on or after January 1, 2014	• 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	• No reduced benefit provisions

Source: Kentucky Retirement Systems.

Table 1.4
Retirement Eligibility Requirements For Kentucky Employees Retirement System/ County Employees Retirement System Hazardous And State Police Retirement System Members

Participation Date	Unreduced Benefit	Reduced Benefit
Prior to Sept. 1, 2008	• Any age with at least 20 years of service or • Age 55 with at least 5 years of service	• Age 50 with at least 15 years of service
Participating on or after Sept., 1, 2008 but prior to Jan. 1, 2014	• 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
Participating on or after January 1, 2014	• Any age with at least 25 years of service or • Age 60 with at least 5 years of service	• No reduced benefit provisions

Source: Kentucky Retirement Systems.

System Benefits

Each system is designed to provide three types of benefits: a monthly retirement benefit for life, disability/death benefits, and health insurance benefits after retirement. Benefits vary based on type of coverage (nonhazardous or hazardous) and the date the employee first began participating in the system. Information on each of these benefits is provided on the following pages.

Monthly Retirement Benefits For Members Participating Prior To January 1, 2014

Benefits for members who began participating in the systems prior to January 1, 2014, are based on the following formula established by statute:

$$\text{Final Compensation} \times \text{Benefit Factor} \times \text{Years of Service Credit} = \text{Annual Benefit}$$

Retirement benefit calculations for members under this formula are provided in Tables 1.5 to 1.8.

Table 1.5
Retirement Benefit Calculation For Kentucky Employees Retirement System/ County Employees Retirement System Nonhazardous Employees Participating Prior to September 1, 2008

Final Compensation	Benefit Factor	Service Credit
Average of highest 5 years of salary	KERS: 1.97 percent, except that the value is 2 percent for employees with 13 months of service between January 1998 and January 1999. CERS: 2.2 percent if participating prior to August 1, 2004, and 2 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, and service credit for accumulated sick leave at retirement

Source: Kentucky Retirement Systems.

Table 1.6
Retirement Benefit Calculation For Kentucky Employees Retirement System/ County Employees Retirement System Nonhazardous Employees Participating On Or After September 1, 2008 But Prior To January 1, 2014

Final Compensation	Benefit Factor		Service Credit
Average of the 5 complete fiscal years immediately preceding retirement	Years of service	Factor	Service earned for time worked in a regular full-time position, purchased service, and up to 12 months of service credit for accumulated sick leave at retirement
	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 of service credit.		

Source: Kentucky Retirement Systems.

Table 1.7
Retirement Benefit Calculation For State Police Retirement System And Kentucky Employees Retirement System/County Employees Retirement System Hazardous Employees Participating Prior To September 1, 2008

Final Compensation	Benefit Factor	Service Credit
Average of highest 3 years of salary	• KERS: 2.49% • CERS and SPRS: 2.50%	Service earned for time worked in a regular full-time position, purchased service, and service credit for accumulated sick leave at retirement

Source: Kentucky Retirement Systems.

Table 1.8
Retirement Benefit Calculation For State Police Retirement System And Kentucky Employees Retirement System/County Employees Retirement System Hazardous Employees Participating On Or After September 1, 2008, But Prior To January 1, 2014

Final Compensation	Benefit Factor		Service Credit
Average of highest 3 complete fiscal years	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, and up to 12 months of service credit for accumulated sick leave at retirement

Source: Kentucky Retirement Systems.

The annual benefit resulting from the calculations in Tables 1.5 to 1.8 above 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.

Retirement Benefit Calculation For Members Participating On Or After January 1, 2014

Members who begin participating in the systems on or after January 1, 2014, are provided retirement benefits through a cash balance plan that provides benefits based on an account balance, rather than on a formula. This change was enacted in Senate Bill 2 during the 2013 Regular Session.

The cash balance plan is not a defined contribution plan but rather a type of defined benefit plan that operates as another benefit tier within the retirement systems. While it is a type of defined benefit plan, it does have several characteristics of a defined contribution plan with individual employee accounts, benefits based on the employee's account balance at retirement (employee and employer contributions and investment returns), and some variability in benefits due to investment returns. It differs from a defined contribution plan in that a minimum level of investment return is guaranteed on the employee accounts, the retirement systems rather than the employee manage investments, and employees can annuitize their account balance upon retirement (to receive it in the form of a monthly benefit).

In the cash balance plan, employees contribute the same amount as newer employees who began participating prior to January 1, 2014, except that the 5 percent of pay (8 percent hazardous duty) they contribute to fund pension benefits will go into their individual accounts, along with an employer pay credit of 4 percent of their salary (7.5 percent hazardous duty). Employees receive a guaranteed return of 4 percent annually and 75 percent of the excess returns above 4 percent (the excess returns is calculated on a 5-year smoothed return).

Employees in the cash balance plan are vested for employer contributions and investment returns on those employer contributions after 5 years. Upon reaching retirement eligibility, employees can take their account balance in a lump-sum or have it annuitized into one of the monthly benefit payment options currently available through the retirement systems for other members.

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 KRS, 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 on their service credit, while employees who begin participating after that date receive a set dollar amount per month for each year of service credit. Tables 1.9 and 1.10 provide details about the benefits for nonhazardous and hazardous-duty members based on their participation dates.

Table 1.9
Retiree Health Insurance Premium Payments For Kentucky Employees Retirement System/County Employees Retirement System Nonhazardous Members

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% 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% annually from date of participation.	

Source: Kentucky Retirement Systems.

Table 1.10
Retiree Health Insurance Premium Payments For State Police Retirement System And Kentucky Employees Retirement System/County Employees Retirement System Hazardous Members

Participation Date In Systems	Eligibility Requirements	Percent Or Dollars Of Premium Paid For The Retiree And Dependents Of The Retiree		
Before July 1, 2003	Must be eligible to retire	Years of Service at Retirement	% of Premium Paid for Retiree	% of Premium Paid for Dependents
		Less than 4	0%	0%
		4, but less than 10	25	25
		10, but less than 15	50	50
		15, but less than 20	75	75
		20 or more	100	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	• $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% annually from date of participation.		
On or after September 1, 2008	Must be eligible to retire; must have at least 15 years of service	• $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% annually from date of participation.		

Note: Percent/dollar amount paid on behalf of a hazardous-duty retiree's spouse/dependents is based solely on 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 his or her 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.

Cost Of Living Adjustments On Monthly Retirement Benefits

After the passage of Senate Bill 2 in the 2013 Regular Session of the General Assembly, members of the systems will no longer receive automatic annual increases of 1.5 percent on their monthly retirement benefits. Language in SB 2 did provide that a 1.5 percent cost of living adjustment (COLA) could be granted if an individual system is 100 percent funded and subsequent legislation authorizes the use of surplus funds to provide the 1.5 percent COLA, or if the General Assembly appropriates or directs payment of funds to prefund the COLA in the year it is provided.

Service Purchases And Sick Leave Service Credit

Many employees participating in the systems can choose to purchase service credit for other public employment or service as established by law, such as military service, federal service, university service, and nonqualified service, provided certain requirements established by state statute are met. In addition, employees of KERS/SPRS agencies and many CERS agencies receive additional service credit for accumulated sick leave at retirement.

Legislative changes in 2002, 2004, 2008, and 2013 have limited the use and impact on retirement eligibility of service purchases and sick leave service credit, particularly for new participants in the systems. The most recent changes in 2013 via SB 2 eliminated service purchases and sick leave service credit for new participants entering the system on or after January 1, 2014, with the exception of omitted service and recontributions of refunds.

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-duty 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.[3]

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

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.

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.

2014 Legislative Changes

Two measures that impacted Kentucky Retirement Systems directly passed during the 2014 Regular Session: House Bill 364 and House Bill 235.

House Bill 364 allows local sheriff's offices to establish a program to reemploy KERS and CERS retirees as deputy sheriffs provided they meet certain requirements and exempts the sheriff's offices from paying employer contributions and health reimbursements to KRS for retirees reemployed under the program.

House Bill 235, the executive branch budget bill, included the full actuarially required contribution rates for KERS and SPRS. More detail on system funding is included in Chapter 2 of this report.

[3] House Bill 364 passed during the 2014 Regular Session, which allows local sheriff's offices to establish a program to reemploy KERS and CERS retirees as deputy sheriffs provided they meet certain requirements, exempts the sheriff's offices from paying employer contributions and health reimbursements to KRS for retirees reemployed under the program.

Chapter 2

Kentucky Retirement Systems Funding And Investments

System Funding

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. Employer contribution rates vary based on the results of actuarial valuations completed by KRS, with CERS rates being subject to adjustment annually, and KERS and SPRS employer rates being subject to adjustment every 2 years to coincide with the biennial executive branch budget.

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 or after that date 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 or after that date contribute 9 percent of their pay, with the additional 1 percent going to fund retiree health benefits.

The Actuarial Valuation Process

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.). Key actuarial assumptions include investment return, mortality rates, future medical inflation rates, and payroll growth. KRS is required by statute to perform an actuarial experience study at least once every 10 years to review the funding methods and assumptions used in the actuarial valuation.

2) **The financial health of the systems.** In the valuation, the actuary reports several statistics useful in evaluating the financial health of the systems 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 that 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 assumptions used by the systems' actuary, the systems' actual experience against those assumptions, and the level of funding made by the employer.

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

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

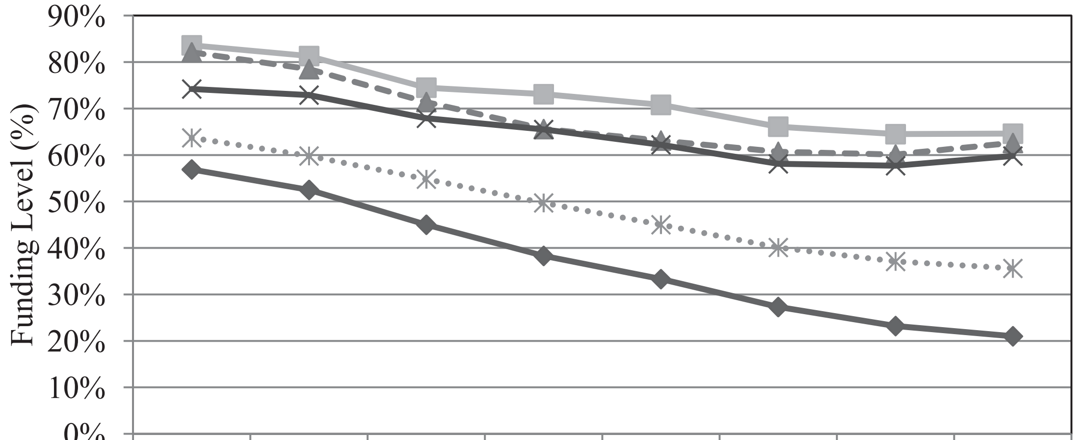
3) **The level of employer contributions:** The employer contribution for each of the systems includes two contributions: one to fund pension benefits and one to fund retiree health benefits. Each of these individual contributions comprises two components: a payment for normal cost (the estimated cost of the upcoming year of service for active employees) and a payment to finance the unfunded liability over a specific time period (30-year closed period as of the 2013 actuarial valuation). Employer contributions vary based on the level of unfunded liabilities and financial health of the individual system. As unfunded liabilities increase (or decrease), then the level of employer contribution rates needed to fund the system increase (or decrease). Employer rates can also vary based on funding policies established by statute and by the KRS Board of Trustees. Actuarial valuation results are applicable to employer contributions payable in the budgeting period that follows the valuation. For example, the FY 2015 CERS employer rates were determined by the 2013 actuarial valuation.

Financial Health Of The Systems

The 8-year historical funding levels and unfunded liabilities for each system's pension and health insurance funds, as reported in the KRS annual actuarial valuations, are provided in Figures 2.A to 2.D. This period includes the downturn in investment markets that occurred in FY 2008 and 2009.

From the 2007 to 2013 actuarial valuation, funding levels for each of the KERS, CERS, and SPRS pension funds continued to fall, while unfunded liabilities continued to increase for each fund. However, in the 2014 actuarial valuation, the CERS and KERS hazardous pension funds shows improvement for the first time since the 2000 actuarial valuation. Over the same period, funding levels for each of the KRS retiree health funds have generally improved, and unfunded liabilities have fallen accordingly.

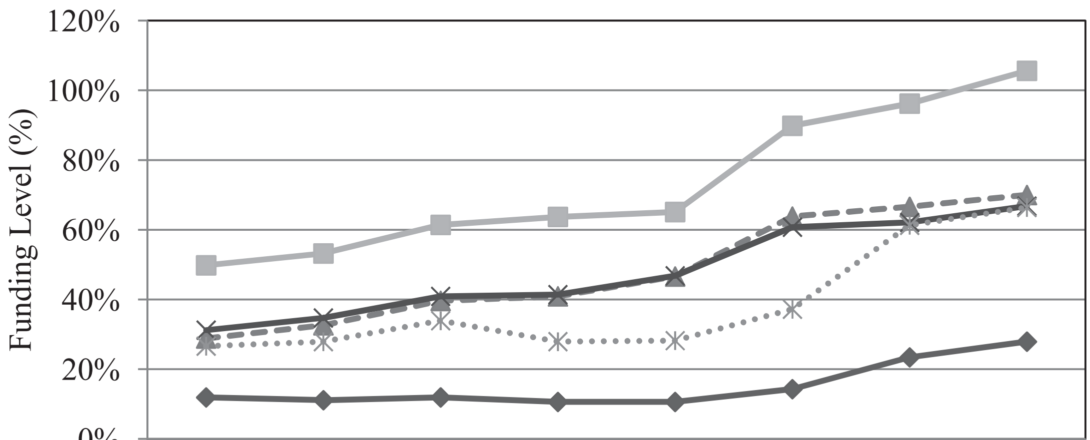
Figure 2.A
Eight-Year Historical Funding Levels KRS Pension Funds



	2007	2008	2009	2010	2011	2012	2013	2014
KERS NH	56.9%	52.5%	45.0%	38.3%	33.3%	27.3%	23.2%	21.0%
KERS H	83.6%	81.3%	74.5%	73.1%	70.8%	66.1%	64.5%	64.6%
CERS NH	82.1%	78.5%	71.4%	65.6%	63.1%	60.7%	60.1%	62.6%
CERS H	74.2%	72.9%	67.9%	65.5%	62.2%	58.1%	57.7%	59.8%
SPRS	63.7%	59.8%	54.8%	49.7%	45.0%	40.1%	37.1%	35.6%

Source: Kentucky Retirement Systems.

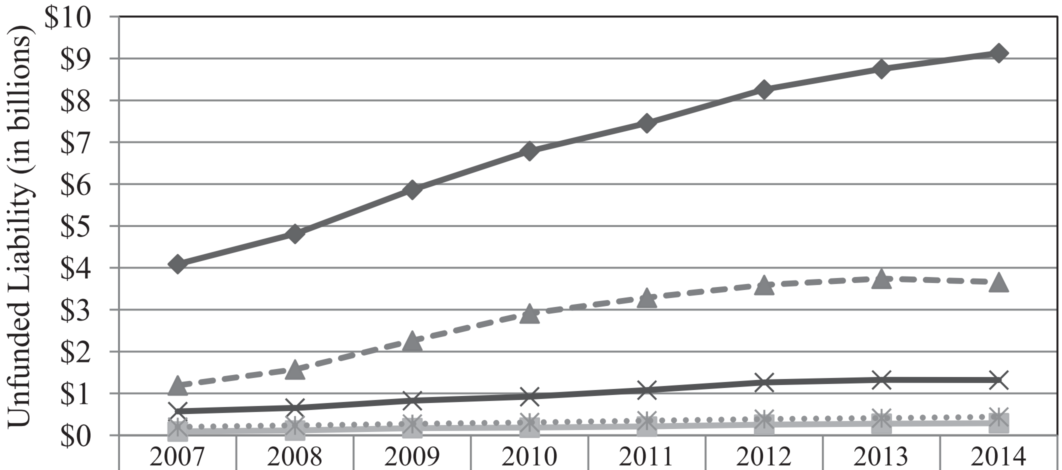
Figure 2.B
Eight-Year Historical Funding Levels KRS Retiree Health Funds



	2007	2008	2009	2010	2011	2012	2013	2014
KERS NH	11.9%	11.1%	11.9%	10.6%	10.6%	14.3%	23.4%	27.9%
KERS H	49.8%	53.2%	61.4%	63.7%	65.1%	89.9%	96.2%	105.6%
CERS NH	28.8%	32.6%	39.6%	40.9%	46.6%	63.8%	66.6%	70.0%
CERS H	31.2%	34.7%	40.9%	41.4%	46.8%	60.7%	62.1%	66.8%
SPRS	26.6%	27.9%	33.9%	27.9%	28.2%	37.2%	61.3%	66.4%

Source: Kentucky Retirement Systems.

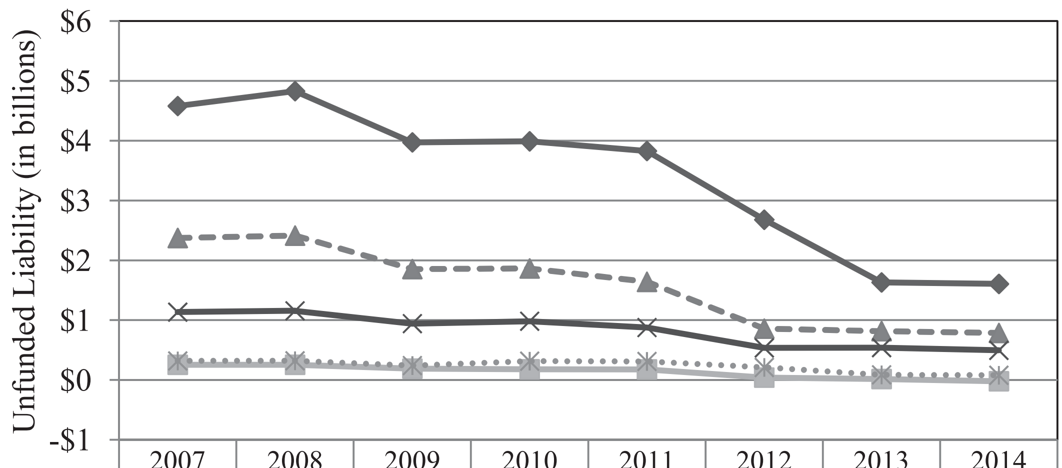
Figure 2.C
Eight-Year Historical Unfunded Liabilities: KRS Pension Funds



	2007	2008	2009	2010	2011	2012	2013	2014
KERS NH	$4.09	$4.81	$5.86	$6.79	$7.46	$8.26	$8.75	$9.13
KERS H	$0.09	$0.12	$0.17	$0.19	$0.21	$0.26	$0.28	$0.29
CERS NH	$1.19	$1.57	$2.26	$2.91	$3.29	$3.59	$3.74	$3.66
CERS H	$0.57	$0.65	$0.83	$0.92	$1.08	$1.26	$1.32	$1.32
SPRS	$0.20	$0.24	$0.27	$0.31	$0.35	$0.39	$0.41	$0.44

Source: Kentucky Retirement Systems.

Figure 2.D
Eight-Year Historical Unfunded Liabilities: KRS Retiree Health Funds



	2007	2008	2009	2010	2011	2012	2013	2014
KERS NH	$4.58	$4.83	$3.97	$3.99	$3.83	$2.68	$1.63	$1.61
KERS H	$0.25	$0.25	$0.19	$0.18	$0.18	$0.04	$0.02	-$0.02
CERS NH	$2.37	$2.41	$1.85	$1.87	$1.64	$0.86	$0.82	$0.79
CERS H	$1.13	$1.16	$0.94	$0.98	$0.88	$0.54	$0.54	$0.50
SPRS	$0.32	$0.32	$0.24	$0.31	$0.31	$0.21	$0.09	$0.08

Source: Kentucky Retirement Systems.

Factors Impacting Unfunded Liabilities

Following the 2013 actuarial valuation, the systems had their consulting actuary evaluate the factors that have led to the growth in higher unfunded liabilities from the 2007 to 2013 actuarial valuation for the each of the KRS pension funds—analysis that includes the 2014 actuarial valuation has not been completed. These factors include investment returns less than assumed; cost-of-living adjustments that were not prefunded (Senate Bill 2 removed the automatic COLA); benefit changes; 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. Table 2.1 details these factors for each pension fund administered by KRS.

Table 2.1
Unfunded Liability Growth From The 2007 To 2013 Actuarial Valuations
Kentucky Retirement Systems Pension Funds

	KERS NH	KERS H	CERS NH	CERS H	SPRS
2007 Unfunded Liability	$4.089 billion	$0.092 billion	$1.192 billion	$0.569 billion	$0.199 billion
Investment Experience	+1.378	+0.115	+1.462	+0.485	+0.075
Employer Rate Reductions	+1.299	+0.020	NA	NA	+0.049
Cost-of-Living Adjustments	+0.782	+0.039	+0.418	+0.162	+0.049
Demographic/Salary Experience	+0.022	+0.004	+0.118	+0.013	+0.018
Assumption Changes	-0.012	+0.010	+0.044	-0.004	-0.003
Benefits	-0.045	-0.006	None	None	-0.010
Other Factors	+1.239	+0.005	+0.509	+0.097	+0.033
2013 Unfunded Liability	$8.751 billion	$0.278 billion	$3.742 billion	$1.323 billion	$0.410 billion

Note: NH means nonhazardous duty and H means hazardous duty.
Source: Kentucky Retirement Systems. Unfunded Actuarial Liability Attribution.

KRS has not performed an analysis on the retiree health funds and the factors responsible for the changes in unfunded liabilities. However, KRS has indicated that improving actuarial statistics are generally due to increased employer contributions, favorable investment and medical inflation experience, and changes in actuarial assumptions and benefits.

Employer Contribution Levels

Employer contribution rates paid by participating agencies differ by retirement system and fluctuate based on the financial health of that individual system as determined by the actuarial valuation and the funding policies established by statute and by the board of trustees. Generally speaking, as unfunded liabilities in the system increase or decrease so do the employer contribution rates established by the systems.

For KERS and SPRS, employer contribution rates established by the KRS Board of Trustees vary every 2 years to coincide with the state's biennial budgeting process.[4] The current state biennial budget provided the employer contribution rate established by the KRS Board of Trustees for FY 2015 and FY 2016 for KERS and SPRS in accordance with state statute and as recommended by the 2013 actuarial valuation. However, the prior six biennial budgets provided for an employer contribution rate less than the amount established by the KRS Board of Trustees. Tables 2.2 to 2.6 show the KERS and SPRS employer contribution rates established by the KRS Board of Trustees and the amount provided in the biennial state budget from FY 2009 to FY 2016.

Table 2.2
Kentucky Employees Retirement System Nonhazardous Employer Contribution Rates Since Fiscal Year 2009
As A Percentage Of Payroll

Fiscal Year Ended	Rate Established By The KRS Board			Total Budgeted Rate
	Pension	Retiree Health	Total	
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
2014	32.57	12.71	45.28	26.79
2015	30.84	7.93	38.77	38.77
2016	30.84	7.93	38.77	38.77

Source: Kentucky Retirement Systems.

[4] Senate Bill 2 provided that the Kentucky Retirement Systems Board of Trustees could only amend the KERS and SPRS employer contribution rates every 2 years to coincide with the biennial state budget. This change was effective with KERS and SPRS employer contribution rates payable on or after July 1, 2014. Actuarial valuation results are applicable to employer contributions payable in the budgeting period that follows. For KERS and SPRS, the FY 2015 and FY 2016 employer rates were determined by the 2013 actuarial valuation.

Table 2.3
Kentucky Employees Retirement System Hazardous Employer Contribution Rates
Since Fiscal Year 2009
As A Percentage Of Payroll

Fiscal Year Ended	Rate Established By The KRS Board			Total Budgeted Rate
	Pension	Retiree Health	Total	
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
2014	17.00	11.84	28.84	32.21
2015	16.37	9.97	26.34	26.34
2016	16.37	9.97	26.34	26.34

Source: Kentucky Retirement Systems.

Table 2.4
State Police Retirement System Employer Contribution Rates
Since Fiscal Year 2009
As A Percentage Of Payroll

Fiscal Year Ended	Rate Established By The KRS Board			Total Budgeted Rate
	Pension	Retiree Health	Total	
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
2014	53.35	43.17	96.52	71.15
2015	53.90	21.86	75.76	75.76
2016	53.90	21.86	75.76	75.76

Source: Kentucky Retirement Systems.

As shown in Tables 2.5 and 2.6, for CERS, employer contribution rates established by the KRS Board of Trustees vary annually based on the results of the most recently completed actuarial valuation. Of the total employer contribution rate, the pension contribution is paid at the full actuarially determined rate, but the retiree health contribution is being phased-in to the full actuarially determined rate through FY 2018 based on the 10-year schedule established by House Bill 117 passed in 2009.

Table 2.5
County Employees Retirement System Nonhazardous Employer Contribution Rates
Since Fiscal Year 2009
As A Percentage Of Payroll

Fiscal Year Ended	Pension	Retiree Health	Total
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
2014	13.74	5.15	18.89
2015	12.75	4.92	17.67
2016	12.42	4.64	17.06

Source: Kentucky Retirement Systems.

Table 2.6
County Employees Retirement System Hazardous Employer Contribution Rates
Since Fiscal Year 2009
As A Percentage Of Payroll

Fiscal Year Ended	Pension	Retiree Health	Total
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
2014	21.77	13.93	35.70
2015	20.73	13.58	34.31
2016	20.26	12.69	32.95

Source: Kentucky Retirement Systems.

2014 Actuarial Experience Study

KRS is required by statute to complete an actuarial experience study at least once every 10 years. However, KRS, in conjunction with its consulting actuary, typically performs the study once every 5 years. The purpose of the experience study is to evaluate the current assumptions and funding methods (what was supposed to happen) against the experience of the systems (what actually happened) and to determine whether changes to assumptions and methods should be adopted.

The KRS Board of Trustees received recommendations for changes from its consulting actuary in April 2014 and ultimately adopted the changes in December 2014. The Public Pension Oversight Board reviewed these changes at the May meeting and received an update on the adopted changes at the December meeting. The key changes were to reduce the investment return assumption from 7.75 percent to 7.5 percent and to reduce wage inflation from 4.5 percent to 4 percent. Other demographic changes were made as well.

The assumption changes adopted by the KRS Board of Trustees will be effective with the 2015 actuarial valuation and will impact employer contribution rates payable in FY 2017 and after. The net impact, assuming there are no other actuarial gains or losses recorded in the next actuarial valuation, will be to increase employer contribution rates for all systems except for the CERS hazardous system.

The most significant increase will occur in the KERS nonhazardous employer rates, which are anticipated to increase based on the results of the actuarial experience study and also the additional actuarial losses recorded in the 2014 actuarial valuation. Provided there are no additional gains or losses recorded in the 2015 actuarial valuation, the KERS nonhazardous employer contribution rate of 38.77 percent of payroll in the current state biennial budget could increase to 44.80 percent of payroll in the next state biennial budget.

2014 Audited Financial Statements

For the fiscal year ended June 30, 2014, the combined net plan assets of the KRS pension funds increased by $862.8 million to $12 billion. Individually, net plan assets improved for all pension funds with the exception of the KERS nonhazardous pension fund, which experienced a $187 million reduction in net plan assets over the year. Pension net plan assets at the beginning of year (BOY) and end of year (EOY) for the fiscal year ended June 30, 2014, and the additions and deductions that resulted in the net plan asset change over the year is provided in Table 2.7 for each system administered by KRS.

Table 2.7
Kentucky Retirement Systems Pension Funds
Net Plan Assets and Changes in Net Plan Assets
(in millions)

	KERS NH	KERS H	CERS NH	CERS H	SPRS
Net Plan Assets (BOY)	**$2,761**	**$515**	**$5,796**	**$1,834**	**$249**
Additions					
Employee Contributions	$93	$12	$122	$43	$5
Health Insurance (HB 1)	5	<1	6	1	<1
Employer Contributions	297	12	324	115	20
Net Investment Income	338	81	893	288	40
Total Additions	**$732**	**$105**	**$1,348**	**$447**	**$66**
Deductions					
Benefit Payments	$890	$54	$583	$190	$53
Refunds	14	3	14	3	<1
Administrative Expenses	11	1	19	2	<1
Total Deductions	**$915**	**$58**	**$616**	**$194**	**$53**
Net Plan Assets (EOY)	**$2,578**	**$561**	**$6,528**	**$2,087**	**$261**

Notes: The Health Insurance contribution is the 1 percent of pay contribution made by employees who began participating in the systems on or after August 1, 2008, as provided in 2008 HB 1. The employee contribution, while required to be part of the pension trust assets, is used to fund retiree health benefits.
NH means nonhazardous duty, H means hazardous duty, BOY means beginning of year, and EOY means end of year.
Source: June 30, 2014 KRS Annual Audit.

For the fiscal year ended June 30, 2014, the combined net plan assets of the KRS retiree health funds increased by $632.5 million to $4.2 billion. Individually, net plan assets improved for all retiree health funds. Retiree health net plan assets at the beginning of year and end of year for the fiscal year ended June 30, 2014, and the additions and deductions that resulted in the net plan asset change over the year is provided in Table 2.8 for each system administered by KRS.

Table 2.8
Kentucky Retirement Systems Retiree Health Funds
Net Plan Assets And Changes In Net Plan Assets
(in millions)

	KERS NH	KERS H	CERS NH	CERS H	SPRS
Net Plan Assets (BOY)	**$496**	**$373**	**$1,619**	**$891**	**$143**
Additions					
Employer Contributions	$164	$23	$121	$74	$14
Retiree Premium Pmts.	1	<1	1	<1	<1
Other Additions[5]	2	<1	2	<1	0
Net Investment Income	97	52	232	125	21
Total Additions	**$264**	**$76**	**$357**	**$200**	**$35**
Deductions					
Benefit Payments	$111	$15	$93	$61	$13
Other Deductions[6]	2	<1	4	<1	<1
Administrative Expenses	1	<1	<1	<1	<1
Total Deductions	**$113**	**$15**	**$97**	**$61**	**$13**
Net Plan Assets (EOY)	**$647**	**$434**	**$1,879**	**$1,030**	**$165**

NH means nonhazardous duty, H means hazardous duty, BOY means beginning of year, and EOY means end of year.
Source: June 30, 2014 KRS Annual Audit.

2014 Investments And Investment Performance

As outlined in KRS 7A.250, the Public Pension Oversight Board conducted a semiannual review of Kentucky Retirement Systems' investment program during the board's February and August meetings. The semiannual reviews, which included presentations from KRS investment staff, covered an analysis of asset allocation, performance and volatility, policies, fees and expenses, and securities litigation programs.

Kentucky Retirement Systems Funds

KRS manages two separate pension and retiree health funds for each of the five separate systems it administers. Assets are managed both internally by KRS investment staff and externally by investment managers. The KRS Board of Trustees has authorized and directed a five-member Investment Committee to manage the investment portfolios in accordance with approved policies.

[5] Other Additions includes primarily employer reimbursements for retiree health care for reemployed retirees and minimal receipts from the employer group waiver plan.
[6] Other Deductions includes primarily self insurance funding costs and minimal costs due to excise taxes.

Asset Allocation

KRS assets are diversified across nine major assets classes as determined by the KRS Investment Committee and Board of Trustees. Target asset allocations are largely driven by asset liability modeling studies, which are typically conducted at least once every 5 years by a third party. The next asset liability modeling study is anticipated to occur in 2015.

Assets classes used by KRS include traditional public markets, such as equities and fixed income; and less traditional asset classes typically referred to as alternative assets, such as real return, real estate, private equity, and absolute return. Actual and targeted asset allocations for the KRS pension and retiree health funds, along with two available peer groups, are shown in Table 2.9.

Table 2.9
Kentucky Retirement Systems Asset Allocation As Of June 30, 2014

	KRS Pension Funds		**KRS Retiree Health Funds**		**Peer Groups**	
	Actual	Target	Actual	Target	LRC	Cliffwater
Public Equity	**44.8%**	**43.4%**	**48.3%**	**44.0%**	**51.5%**	**50%**
US Equity	21.6%	20.5%	24.5%	20.0%		
Non-US Equity	23.2%	22.9%	23.8%	24.0%		
Fixed Income	**18.5%**	**19.3%**	**20.1%**	**20.0%**	**21.2%**	**22%**
US Core	11.5%	9.3%	12.9%	10.0%		
High Yield	5.0%	5.0%	5.0%	5.0%		
Non-US Fixed income	2.0%	5.0%	2.1%	5.0%		
Alternatives	**34.3%**	**34.5%**	**29.9%**	**35.0%**	**25.5%**	**25%**
Real Return	10.1%	10.0%	10.2%	10.0%		
Real Estate	3.9%	4.5%	4.1%	5.0%		
Private Equity	10.0%	10.0%	5.7%	10.0%		
Absolute Return	10.4%	10.0%	9.9%	10.0%		
Cash	**2.4%**	**2.8%**	**1.7%**	**1.0%**	**1.8%**	**3%**

Source: Kentucky Retirement Systems.

As shown in the table, both KRS funds have a higher allocation to less traditional asset classes and a below average exposure to public equity and fixed income. According to the *Cliffwater 2014 Report on State Pension Asset Allocation and Performance* conducted by Cliffwater, LLC, a state plan's average exposure to alternative assets was 25 percent, while publically listed stocks accounted for 50 percent of assets. In addition, the Legislative Research Commission (LRC) staff review of public pension plan asset allocations, which included 37 of 50 state employee plans, indicated similar results.

Investment Performance

Pension and retiree health fund performance over the 1-, 3-, 5-, and 10-year periods for the fiscal year ended June 30, 2014, is provided in Table 2.10. Both funds provided positive absolute returns during the fiscal year ending June 30, 2014. The pension fund, which earned 15.6 percent, also posted a result above its policy benchmark. Over a longer 10-year period, both funds have fallen short of the 7.75 percent actuarially assumed rate of return.

Table 2.10
Kentucky Retirement Systems Investment Returns As Of June 30, 2014

	KRS Pension Funds (Net Of Fees)				KRS Retiree Health Funds (Net Of Fees)			
	1-Year	3-Year	5-Year	10-Year	1-Year	3-Year	5-Year	10-Year
Total Fund	15.6%	8.6%	12.0%	6.8%	14.9%	7.5%	12.1%	6.3%
Benchmark	14.9%	8.8%	11.9%	6.8%	15.0%	8.7%	13.0%	6.5%

Source: Kentucky Retirement Systems.

In addition to evaluating KRS relative to stated policy benchmarks, the Public Pension Oversight Board also reviewed KRS investment results against other public fund peer groups: RV Kuhn, Wilshire TUCS, and BNY Mellon. Table 2.11 includes median results from three publically available peer groups, as well as an LRC staff-generated peer group consisting of only US state employee plans. The results reflect a volatile decade that included a significant market downturn. Over a 10-year period, the median fund of each peer group failed to meet KRS's 7.75 percent actuarially assumed rate of return.

Table 2.11
Kentucky Retirement Systems Peer Group Median Returns As Of June 30, 2014

	1-Year	3-Year	5-Year	10-Year
LRC Calculated (37 plans)	17.0%	9.9%	12.8%	7.5%
RV Kuhn's (67+ plans)	16.9%	10.2%	13.1%	7.7%
Wilshire TUCS > 1 billion	17.4%	10.0%	12.8%	7.4%
BNY Mellon (106 plans)	17.2%	-	13.1%	7.4%

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Chapter 3

2014 Public Pension Oversight Board Meetings

Testimony Before The Board

During 2014, the Public Pension Oversight Board met 10 times. Board members were provided testimony regarding KRS benefits, funding, and investments at multiple meetings. Benefits, funding, and investment summaries are included in Chapters 1 and 2 of this report. The board also reviewed issues relative to agency participation and board elections and received testimony and recommendations from various outside interest groups. A summary of these additional issues and testimony is provided below.

Kentucky Retirement Systems Agency Participation

The board discussed agency participation during the March 24, 2014, meeting, focusing on federal issues governing the tax qualified status of the plans, agencies seeking a means to terminate participation, recent court cases concerning agencies, and possible legislative proposals related to these issues.

Federal Issues

The state-administered retirement system plans are tax qualified governmental plans that are exempt from the federal Employee Retirement Income Security Act (ERISA) and do not participate in the protections provided by the Pension Benefit Guaranty Corporation. The Internal Revenue Service has published an advance notice of proposed rulemaking regarding the definition of a governmental plan. In the rule-making process, the federal government will be defining what constitutes a state or a political subdivision of a state, and will likely describe factors and develop a test for what constitutes an instrumentality of a state or a political subdivision of a state, which will give some guidance on the issue. Any adopted rules could limit the types of employers that can participate, or continue to participate, in KRS without jeopardizing the tax qualified status of the plans.

Terminating Participation

Increasing employer contribution rates have put fiscal pressures on participating agencies, leading some to seek a means to terminate their participation in the plans. For example, the employer contribution rate for the KERS nonhazardous plan has grown over time from 5.89 percent in FY 2002 to 38.77 percent in FY 2015. Because statute does not provide a means for an agency to exit the systems, some agencies have taken measures on their own to reduce employee participation or to effectively withdraw from KRS.

Court Cases

Three primary court cases demonstrate the means by which three agencies have attempted to exit the systems. The agencies are Kentucky River Community Care (KRCC), Bluegrass Oakwood, and Seven County Services. KRCC has reduced itself to a one employee agency and has created an "alter ego" employment agency called Go-Hire, through which it has hired back most, if not all, of the KRCC employees to continue doing business. Oakwood has created a new subsidiary agency, Oakwood Community Services, and wants to hire new employees or transfer existing employees to this new subsidiary agency. Seven County Services has filed bankruptcy and is attempting to discharge any obligations owed to the systems.

Legislative Proposals

Several legislative proposals have been considered in the last few years to allow some or all agencies to discontinue participation for either new hires or a combination of new hires and current employees. For example, Senate Bill 201 in the 2012 Regular Session would have allowed regional mental health agencies to discontinue participation in KERS for new hires. Similarly, Senate Bill 168 in 2013 would have allowed KRS and KTRS agencies to discontinue participation for new hires, and Senate Bill 216 in 2014 which would have allowed certain agencies to voluntarily discontinue participation, provided an actuarial study was completed, the employer offered an alternative retirement plan, and the employer paid the full actuarial cost for discontinuing participation.

Kentucky Retirement Systems Board Of Trustees Election Issues

The Public Pension Oversight Board discussed the composition of the KRS Board of Trustees during the April 28, 2014, meeting. Specifically, the method of selecting board members was reviewed and compared to that of other states, with an emphasis on any improvements that might offer KRS cost savings in administering its elections.

The KRS board elections are conducted by sending paper ballots to every eligible voter by first-class mail. The ballots are returned to an external auditor via a post office box, and the auditor tallies the votes and certifies the results to the KRS board. The total cost for the election process is over $100,000 per election for CERS, and $70,000-$75,000 for KERS.

Of the 23 states with elected board members, 7 allow some type of electronic or online voting by members, and 16 exclusively use paper ballots. The Maryland State Retirement and Pension System moved to electronic voting in 2005 and also allows voting by phone. A similar process is used in Alabama and Louisiana, which use an outside election consulting firm that mails ballots to members who may return the paper ballot by mail, or vote online or by phone. In Kansas, members vote online but can request a paper ballot. Texas, Minnesota, and Massachusetts allow paper ballots but also allow online voting. Ohio, Mississippi, and Missouri have statutory authority to conduct electronic trustee elections, but they have not implemented the process to date.

House Bill 324 from the 2014 Regular Session would have allowed KRS to pursue the possibility of conducting board elections electronically and synchronize the election of a newly created CERS board position with other trustee elections.

Testimony And Recommendations From Outside Groups

The Public Pension Oversight Board heard testimony from the Kentucky Chamber of Commerce during its August 28, 2014, meeting, and from employee, employer, and retiree groups during its October 21, 2014, meeting. From that testimony, several recommendations for legislative change were formulated.

- The Chamber of Commerce praised past progress and reforms but expressed concerns over the additional funding needs of the various retirement systems going forward and recommended that the board contract with an independent consultant to review the administration, benefits, and investments by KRS.

- The Kentucky League of Cities (KLC) highlighted issues of concern to cities relating to pension reform in CERS and indicated that its members would focus on getting the pension spiking provisions of SB 2 clarified. Specifically, KLC would like for employees to be permitted to increase compensation over 10 percent per year during their last 5 years of employment, but any amounts over that level would not count toward creditable compensation unless the increase was caused by certain excepted reasons, as provided in 2014 Regular Session SB 142.

- The Kentucky Association of Counties (KACo) noted that retirement payments have surpassed jail payments out of the general fund in some counties, and therefore the largest issue to KACo members is the employer contribution level. KACo is also concerned about the Seven Counties Services bankruptcy proceedings and the $90 million share of unfunded liability attributed to Seven County Services that cities and counties may have to pay.

- The Kentucky Government Retirees discussed the cash crisis facing the KERS nonhazardous fund and requested that the board make recommendations to the 2015 General Assembly to alleviate the problem. The group proposed that the board form a subcommittee to examine pension funding solutions so that recommendations could be adopted for the upcoming 2015 session.

- The Fraternal Order of Police (FOP) discussed issues with restrictions on officer reemployment after retirement. Specifically, the FOP expressed its concerns over the prohibitions on prearranged agreements for reemployment after retirement and the impact it has on an employed deputy or police officer who is eligible to retire but is not permitted to approach a potential new employer prior to retiring. The FOP also would like to see the requirement that a retiree has to have participated in the Kentucky Law Enforcement Foundation Program Fund before being hired under the provisions of 2014 HB 364 addressed so that certain retirees would not need new training. Finally, the FOP said that before a person can accept another peace officer position, the retiree cannot be reemployed for at least

1 month following retirement if in a hazardous position, or at least 3 months if in a nonhazardous position, which impedes some officers from being hired under contracts that mandate positions being filled within a certain time.

- The Kentucky Association of Transportation Employees and the Kentucky Association of Transportation Engineers discussed the concerns that 2014 Regular Session SB 142 would move the obligation for the cost of increased compensation from the employer to the employee in that it would reduce future retirement benefits by removing legitimate overtime pay for hours worked during emergencies, such as with snow and ice removal or inspecting roadways of ongoing projects. The organizations also expressed their concern that the bill may violate the inviolable contract as provided in KRS 61.692.

- The Kentucky Public Retirees expressed their concern with the stability and solvency of the KRS and want to ensure it continues to be fully funded. The group also noted that retirees have not received a cost of living adjustment in 4 years and hope that the General Assembly will pre-fund a COLA for retirees in 2016. The group recommended that any housekeeping bill include a provision to require a vacancy on the KRS board that is in an elected position to be filled by the remaining elected board members.

Chapter 4

Public Pension Oversight Board Recommendations

The Public Pension Oversight Board adopted recommendations at its November 24, 2014, meeting. These recommendations included both legislative recommendations for the 2015 Regular Session of the Kentucky General Assembly and administrative recommendations for the Kentucky Retirement Systems, the Governor in development of the 2016-2018 biennial budget, and the board's topics of study in 2015.

For the 2015 Regular Session of the Kentucky General Assembly, the board approved the following legislative recommendations:

- The Kentucky Retirement Systems housekeeping bill, similar to provisions included in House Bill 324 that did not pass during the 2014 Regular Session, should be enacted. The bill was the Kentucky Retirement Systems' "housekeeping bill." It included legislative changes recommended by KRS including: authorization for KRS to issue monthly retirement allowances to electronic funds transfer (EFT) cards for those retirees who have not elected to receive their monthly retirement allowance paid by EFT to a banking institution; authorization for KRS to conduct board of trustees elections electronically, through promulgation of administrative regulation, rather than through paper ballot; applying interest charges on omitted contributions, which occur when an agency fails to report eligible employees to the systems; synchronizing the election of the three County Employees Retirement System trustee positions; and clerical and technical changes as well as changes to conform to guidance under federal law.

- Legislation to address issues relative to pension "spiking" should be enacted, which may include one of the following options:
    - Measures similar to those proposed in Senate Bill 142 from the 2014 Regular Session; or
    - Measures that retain the existing statutory language but raise the threshold for a pension spike from a 10 percent annual increase in creditable compensation during the last 5 years of employment to 15 percent.

  Pension spiking occurs when an employee receives significant increases in pay immediately prior to retirement that results in higher lifetime benefit payments. Under law passed in 2013 SB 2, KRS employers are required to pay for the additional actuarial costs to the systems that result from any increases in creditable compensation (retirement salary) greater than 10 percent annually during an employee's last 5 years of employment that are not due to bona fide promotions or salary advancements or lump-sum payments for compensatory time. Senate Bill 142, which was introduced in the 2014 Regular Session but did not pass, would have removed the employer payment for spiking and limited future annual creditable compensation growth to 10 percent annually for employees.

- Legislation to include the Kentucky Teachers' Retirement System, the Legislators' Retirement Plan, and the Judicial Retirement Plan to the oversight duties of the Public

Pension Oversight Board (similar to the measures proposed in House Bill 323 from the 2014 Regular Session) should be enacted.

- Legislation that requires each of the state-administered retirement systems to conduct an actuarial experience study once every 5 years (similar to HB 389 from the 2014 Regular Session) should be enacted, and the analysis should be conducted by a different actuary than the actuary completing the annual valuation.

- The General Assembly should secure additional funding to avert any insolvency issues facing the Kentucky Employees Retirement System pension fund.

- The Public Pension Oversight Board supports measures that would provide additional funding to improve the financial health of the systems administered by Kentucky Retirement Systems and in particular measures that would improve the cash flow issues facing the Kentucky Employees Retirement System nonhazardous pension fund.

- Legislation to address KRS agency participation issues that includes measures for voluntary and involuntary cessation of participation (similar to SB 216 from the 2014 Regular Session) should be enacted.

- Legislation to require KRS to incorporate sensitivity analysis into its annual actuarial valuation on key assumptions and the impact on plan funding statistics and funding requirements should be enacted.

The Public Pension Oversight Board also approved the following administrative recommendations for Kentucky Retirement Systems, the Governor, and the board's 2015 study topics:

- Kentucky Retirement Systems should engage an independent actuarial firm, different from its current actuarial firm, to perform an actuarial audit of the assumptions/funding methods and report the findings to the KRS Board of Trustees and the Public Pension Oversight Board.

- Relative to the actuarial experience study, the KRS Board of Trustees should:
  - Consider the results of any actuarial audit that is completed prior to the board's adoption of any specific assumption/method changes.
  - Evaluate the cash flow needs of the KERS nonhazardous pension fund as it relates to the assumptions/methods.
  - Move quickly on adoption to ensure a timely completion of the asset/liability modeling study and to ensure sufficient notice is provided to employers if any changes in employer contributions will result.

- KRS should take more action in publicizing its board meeting dates and times, including but not limited to
  - Improving electronic communication regarding meetings via the KRS newsletter, website, and social media pages.
  - Distributing meeting dates and times electronically to employee, retiree, and interest groups.

- In developing the 2016-2018 executive branch budget for presentation in the 2016 Regular Session of the General Assembly, the Governor should include the actuarially required contribution rate as required by state statute for KERS and SPRS.

- In 2015, the Public Pension Oversight Board shall:
    - Receive quarterly cash flow statistics from KRS and study cash flow issues facing the systems;
    - Study KRS administrative expenses, approval process, and conduct national comparison;
    - Study investment oversight/structure of other public pension funds;
    - Study the personnel and compensation system of KRS; and
    - Study and review data on other public pension funds as it relates to investment fees, expenses, and required disclosure.