Evaluating Kentucky State Pension Plans in the 2000s and Best Practices Moving Forward

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Section I.

A. Executive Summary

The Commonwealth of Kentucky sponsors three different pension retirement systems. This includes Kentucky Employee Retirement System, Teacher’s Retirement System, and Kentucky’s Judicial Form of Retirement System. Kentucky has one of the worst funded pension retirement plans and is currently facing shortfalls of about $43 billion (PEW, 2013). Between 1998-2008, Commonwealth of Kentucky’s legislators made many detrimental policy decisions that negatively affected its Pension Retirement System. The most impacting includes:

- Enhancements of Benefits in the Nineties
- Changing Final Compensation from the average of five-years to the average of three-years
- Mandated Yearly Cost of Living Adjustments (COLA)
- Not requiring the State to make full payments

In 2012, the Commonwealth established the Kentucky Public Pension Task Force to help identify why the pension retirement system was tremendously underfunded. The following year, due to the recommendations received by the task force, a new policy was enacted that changed

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1 See Appendix C for more information
the pension plan from a defined contribution (DC) plan to a cash balance (CB) plan. This would ultimately shift some of the responsibility from the employer to the employees. It would also now require that COLA be paid before benefits were received.

In the beginning of the 2000s, the Kentucky Retirement Plan had a funding ratio over 100%. Over the past two decades, the funding amount continued to slowly decline and now has about a 31% funding ratio. Even with the reform in 2013, the Commonwealth still has a lot to accomplish in order to get out of this pension crisis and better fund its pension commitments. Going forward, legislators should consider changing the current new hires plan to a defined contribution and be funding it annual required contribution (ARC). It will need to keep its promises to state and local employees while making those promises more financially sustainable.

B. Introduction

There are many sources that led to the Commonwealth of Kentucky’s astronomical funding gap including: investment returns short falls, failure to pay cost of living adjustments, employer contribution shortfalls, assumption changes, and assumption not being met. Throughout the 2000s, one will see the challenges presented to policy makers and how they try to fix the funding gap that continues to grow effortlessly. In this paper, I will examine Kentucky Employee Retirement System throughout the 2000s and discuss policies that affected the retirement plan. I will also recommend the best practices moving forward that will help give relief to the unfunded liabilities.

C. Overview of Kentucky Pension System

The Kentucky Pension Retirement System was created by the General Assembly in the mid-1950s. It was supposed to supplement Social Security benefits for state employees. In the
beginning, the Kentucky retirement system included Kentucky Employees Retirement System, the County Employees Retirement System, and the State Police Retirement System (PEW, 2013). However, the Kentucky Pension Retirement System has changed drastically from the 1950s. Currently, the state of Kentucky’s law has established three major retirement systems. The systems administered are Kentucky Retirement Systems (KRS), Teachers’ Retirement System of Kentucky (TRS), Kentucky Judicial Form Retirement System (KJFRS). The graph below, provided by the Office of State Budget Director, shows the breakdown of Kentucky’s Pension Systems (PRM Consulting Group, 2017). It is important to note that the KERS is further subdivided into different tiers. The tiers represent the different policies enacted to change the pension retirement system for KERS members.

- Tier 1: Before 9/1/2008
- Tier 2: Between 9/1/2008 and 1/1/2014
- Tier 3: On or after 1/1/2014
The retirement systems collectively pay for state and local government, school district employees, some state universities and government related non-profit entities. The systems offer both pension and Other Post-Employment Benefits (OPEB) to each retiree and beneficiaries. This is primarily medical insurance coverage, dental, vision, and life insurance. Kentucky’s retirement systems cover 204,580 active state, local, school, and nonprofit employees, 35,377 vested from former employees not yet at retirement and 166,480 retirees already collecting benefits, for a total of 406,437 persons (PFM & PRM Consulting Group, 2017). The graph below provided by the Office of State Budget Director, shows the most current data of Kentucky’s Retirement Plan Characteristics (PRM Consulting Group, 2017).

<table>
<thead>
<tr>
<th>Source of Employer Funding</th>
<th>KRS</th>
<th>TRS</th>
<th>KJFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>70% state non-hazardous, 98% state hazardous, 142 nonprofit and others</td>
<td>Local governments</td>
<td>55% State</td>
<td>State</td>
</tr>
<tr>
<td>Active Members</td>
<td>Inactive Members</td>
<td>Active Members</td>
<td>Inactive Members</td>
</tr>
<tr>
<td>70% state non-hazardous, 98% state hazardous, 142 nonprofit and others</td>
<td>44,004</td>
<td>3,986</td>
<td>$11,122.4</td>
</tr>
<tr>
<td>State</td>
<td>80,664</td>
<td>9,084</td>
<td>71,848</td>
</tr>
<tr>
<td>Local governments</td>
<td>65</td>
<td>1,515</td>
<td>8.563</td>
</tr>
<tr>
<td>State</td>
<td>51,563</td>
<td>212.1</td>
<td></td>
</tr>
<tr>
<td>Unfunded Actuarial Liability ($ in Millions)</td>
<td>16.0%</td>
<td>59.7%</td>
<td>30.3%</td>
</tr>
</tbody>
</table>

D. Kentucky’s Pension Status

The Commonwealth of Kentucky has one of the worst-funded pension systems throughout the country (PEW, 2013). The Commonwealth’s retirement system in aggregate underfunding has been calculated by the credit rating agency, Standard’s and Poor’s, as the worst among 50
states with just 34.7% of total current obligation now funded, compared to the national median of 74.6% in fiscal year 2015 (PRM Consulting Group, 2017). Assets do not seem to be catching the pace of the liabilities. Ultimately, increasing the funding gap at a rate that is becoming unmanageable and a persistent financial issue for legislators. As of 2016, the liabilities totaled $63 billion, and assets only totaled $20 billion. In turn, leaving Kentucky facing a funding gap of $43 billion (The PEW Charitable Trust, 2013). The Kentucky Employee Retirement Plan makes up $13.47 billion of the unfunded liabilities. This number was slightly higher in 2017 at $13.6 billion (Loftus, 2018).

The Office of the State Budget Director published a report that found the KERS-NH is the most severely underfunded of Kentucky’s plans at just 16% (PRM Consulting Group, 2017). In 2017, the KERS-NH had a shortfall of $11.1 billion and made up one-third of the Commonwealth’s $32.8 billion combined pension Unfunded Actuarial Liability (under current assumptions) (PRM Consulting Group, 2017). This plan has more retirees receiving benefits than active members. Currently, there are 44,004 retirees receiving benefits, and 37,779 active members. The KERS-H has a better funding status due to its smaller size. There are 3,966 retirees receiving benefits and 3,959 active members. KERS-H current liability is $377.3 million.

The SPRS has a larger unfunded liability in 2017 of $540.6 million. Even smaller in size than the KERS-H, there are 1,515 retirees receiving benefits and 908 active members. There is a uniqueness to the KERS-H and SPRS because participants retire earlier due to the hazard their job requires. The CERS-NH has a $4.5 billion liability and covers 80,664 active participants and provides retiree benefits to 56,339 participants. This plan is considered the largest in the state by memberships (PRM Consulting Group, 2017). However, these liabilities are considered to be liabilities of the local government and other government related entities. They typically have
paid the full ARC. Lastly, the CERS-H has a smaller number of participants. There are 8,563 retirees and 9,084 active participants receiving benefits. There total liability is a little under $1.6 billion. (PRM Consulting Group, 2017)

According to a news article published by the Courier Journal in November of 2018, Kentucky employee (hazardous) fund is 55.5 percent funded, up from 54.1 percent last year. Local government employees (nonhazardous) fund is 52.7 percent funded, down slightly from 52.8 percent last year. Local government employees (hazardous) fund is 48.4 percent funded, up from 48.1 percent last year. State Police fund is 27.1 percent funded, up slightly from 27 percent the previous year (Loftus, 2018). Kentucky’s primary pension fund only had 12.9 percent of the money it needed to make future payments to retirees. This was less than the year before, where Kentucky had 13.6 percent.

Since fiscal year 2017, Kentucky Governor Matt Bevin and legislators have been fully paying the fund’s recommended annual contributions in the state budget. While this amount has slowed the growth of the pension debt, it has been offset by a 15 percent spike in retirements in fiscal year 2018 (Cheves, 2019).

Section II.

A. Purpose

There have been significant policy changes that have played a key role in the Commonwealth of Kentucky’s pension crisis. The policy changes, meeting the ARC, actuarial assumptions, investment markets, and cost of living adjustments has become a crucial part for funding pensions. The following section gives a brief summary of Kentucky’s economy, identify key legislative actions on pensions, and explains how the pension system was affected during a specific time period. This information will demonstrate significant periods of time where policy
tried to combat the declining conditions of the economy, market, and pension systems financial health.

B. History of Pension System, Major Impacting Policies, & Pension Financial Health

Prior to 2000s

The economic boom at the end of the 20th century left the Commonwealth of Kentucky’s pensions with excess funding. The funding level during 1998 and 1999 were 115% and 121.90%, respectively (Bluegrass Institute, 2018). Due to this excess funding, legislators approved retroactive enhancements to benefits without making the requisite changes to payroll contribution and investment assumptions. An example of a benefit enhancement that was granted is increasing benefit factor. KERS-NH benefit factor increased from 1.97% - 2.20% between 1998 to 2008 (Bluegrass Institute, 2018). When the market began to correct itself, it left the enhancements unaffordable, and the unfunded liabilities began to grow. (Gregory, 2017)

Early 2000s

The last time Kentucky saw a surplus of pension assets was in the early 2000s. During 2000 through 2002, assets were greater than the liabilities. In 2000, the stock market began to decline, and that became another contributor to the pension funding gap. The stock market crisis in the early 2000s had a direct impact on the pension investment return. Gary Findlay, executive director of the Missouri State Employees Retirement System and President of the National Association of State Retirement Administrators, estimated an average loss of 10% of their value in the stock market decline that began in March of 2000s (PEW, 2002). Kentucky’s loss was above the average. According to Kentucky’s 2001 Annual Actuarial Valuation, the expected valuation of assets was $7,184,787,421. However, the actual market value was $5,484,563,749.
Kentucky loss $1,700,223,672 or 24%. Kentucky also had policy changes that affected the funding gap. In 2001, Kentucky enacted HB 278. This law stated:

- The definition of final compensation was changed for employees of the Kentucky Employee Retirement System and the County Employee Retirement System to the three fiscal years with the highest average monthly salaries (changed from five years) for retirement between August 1, 2001 and January 1, 2009, with a minimum 27 years of service and with age plus years of service totaling at least 75. [This definition previously applied only to employees in hazardous occupations.]

- Cost of purchasing service credit was altered to 100 percent of the actuarial cost of the service, which will increase the cost of most types of purchase, as of July 1, 2001. This legislation replaces various purchase provisions with a common schedule.

According to lawmakers, the differential between computing the final compensation with the final three years verses the old policy of five years, would be balanced by increasing the cost of purchasing service credits. KRS also notes that most purchases would have increased in cost in any case because of findings in recent actuarial studies and the shift from high-5 calculation of final average salary for benefits calculations (Knell, 2000-2014). As much as H.B. 278 may not have impacted the funding gap that year, it would eventually become an issue because the change in computing the final compensation would increase the cost of the pension benefits. One would expect the final three years of an individual’s salary to be the highest.

Overall, Kentucky’s Retirement Systems between 2000 to 2001 had a decrease in combined net assets by $920.8 million. Salaries totaled $3.5 billion. This showed an increase in payroll by $225 million. Employer contribution totaled $288.1 million. This decreased by $17.1 million from the previous year. A portion of the employer contribution was transferred to the insurance fund. During this time, four of the five pension funds experienced a decrease in employer contribution. The decline in net assets is in relation to the beginning of the less favorable market conditions. Net investment income also saw a decline by 217%. A loss of
$698.5 million compared to the income of $593.7 million. This reduction between fiscal years was caused by less appreciation in the fair market value of investments between June 30, 2001 than for the year ended in June 30, 2000. This year the funding ratio was about 139.50%.

(Bluegrass Institute, 2018). (Mitchell, 2001)

In 2002, Kentucky’s financial position was not secure. Kentucky was one of nineteen states to start the fiscal year without a final budget. By the end of 2002, the budget was in a $63.9 million deficit that really strained its financial resources. While facing financial woes, Kentucky decided to enact new legislation targeting its pensions system. H.B. 309 added the following:

- Created the Partial Lump Sum Option (PLSO) retirement benefit for members of the Kentucky Retirement Systems. A retiree may choose a lump-sum payment of 12, 24 or 36 times the monthly benefit, with or without a survivor’s option.

- Authorized the Kentucky Retirement Systems to hire an adequate number of staff to make it more responsive to members’ needs. The Board may set a personnel classification and compensation system with benefits and protections comparable to those of the state personnel system.

- Requires that employees be vested in the Kentucky Retirement Systems before purchasing most types of service credit, with the goal of reducing employer liabilities for insurance benefits by preventing short-term employees from purchasing large amounts of retirement service (source: H.B. 309 Actuarial Cost Analysis).

- Allowed vested members of the Kentucky Employee Retirement System and certain other state systems to purchase any amount of military service credit regardless whether the person is eligible for a military pension. Participating employees over the age of 65 with at least 15 years of service may purchase up to four years’ worth of active-duty service credit at 50 percent of the actuarial cost. All other purchases are at actuarial cost.

Between 2001-2002, the state of Kentucky continued to see assets decreased by $856.4 million. Salaries continued to increase by $3.8 billion and payroll grew by $238 million. Unlike 2000-
2001, employer contributions increased in the pension fund by $5.5 million and total $293.6 million. The increase was separated between the pension and insurance fund and changed by $26.3 and $267.3, respectively. Fair value of investments in the pension fund depreciated by $872.6 million. This amount included a realized loss on sale of investment of $664.3 million. The funding ratio began to decline, and was about 120.42% (Bluegrass Institute, 2018).

In 2003, Kentucky was considered to be in a slow period of recovery from the previous two-year recession. During this time, the State of Kentucky continued to see deterioration of revenue collections and by the end of the fiscal year was $75 million short of the estimated amount that had been most recently revised during the 2003 Session. This amount was offset by a combination of factors, including, U.S. Congress providing $69 million for ongoing General Fund supported activities, and some administrative expenses. This support helped the state of Kentucky at the end the year with undesignated fund balance of $139 million. (Rudolph, Comprehensive Annual Financial Report, 2000-2016)

New legislative policy that affected pensions were:

- **HB 430** provides that employees hired July 1, 2003 or after will be required to earn at least 120 months of service credit before they will be eligible for insurance benefits at retirement. The percentage of the monthly insurance contribution paid for employees hired after July 1, 2003 is 0-119 months., none; 120-179 months, 50%; 180-239 months, 75%; and 240 months or more, 100%. The 120-month service requirement will be waived if the employee is disabled in the line of duty or killed in the line of duty.

- **HB 461** provides that employees who retired and returned to work with a participating agency prior to August 1, 1998, may be eligible to purchase the period of reemployment, if the following conditions are met: Retirement from one of the retirement systems administered by the Kentucky Retirement System and re-employment before August 1, 1998 in a regular full-time position, earning less than the maximum permissible earnings under the Federal Social Security Act; participation in a second retirement account effective August 1, 1998; at least 48 months of service if age 65 or older, or at least 60 months of service if under age 65, in a second account in the systems administered by Kentucky Retirement Systems.
Ultimately, Kentucky tightened eligibility for future retirees’ health benefits through minimum service requirements. The combined net assets in fiscal year 2002-2003 increased by $5.5 million. Covered payroll totaled $4 billion and increased by $228 million from the previous fiscal year. Employer contribution amount totaled $277 million. This decreased by $16.5 million. Contribution by employees totaled $314.8 and $268.8 million for year ends in 2003 and 2004. Fair value of investments was $110 million. There were realized losses on sale of investments of $155.2 million. The pension fund realized losses of about $664.3 million and was a result of the unfavorable market. There was a decline in investment income by approximately $49.6 million. (Dean Borton Allen Ford, 2000-2016) During 2004, the funding ratio had the biggest drop since 1991. The funding ratio was now 97.41% (Bluegrass Institute, 2018).

In 2004, Kentucky economy continued to recover from the recession that began in 2001. The infrastructure that was built during the economic surge of the nineties, was starting to pay off in terms on productivity improvements. However, it did not immediately increase Kentucky’s employment in the high-wage manufacturing. This increase in employment would not be until the second half of 2004. Most notable, the year was marked by gubernatorial transition, budget reduction action, and a modest upturn in the state’s economy and revenue collection towards the end of the fiscal year. (Rudolph, Comprehensive Annual Financial Report, 2004)

The legislation actions with pensions and benefits that was passed during this year reflected the cutbacks that were being made by the state of Kentucky. The new legislative actions were:

- **Health Coverage Chapter 33, Laws of 2004 (HB 290)**, provides that state and county employee retiree health insurance shall not be considered as benefits protected by the inviolable contract provisions of the Kentucky Statutes. The General Assembly reserves the right to suspend or reduce retiree insurance
benefits if in its judgment the welfare of the Commonwealth so demands. The law also provides that no employee hired after July 1, 2003, is entitled to retiree health benefits unless the employee has earned 120 months of service credit in a state retirement system. (For full law please see Appendix A)

- **Benefits-Kentucky, HB 290** reduced the multiplier for members of the County Employee Retirement System from 2.25 to 2% for employees whose participation begins on or after August 1, 2004.

Between 2003-2004, combine net assets of all pension funds administered by KRS increased by $966.1 million. Covered payroll increased by $93 million. Employer contribution continued to grow by $65.1 million and the total contributed was $342.1 million. $104.3 million was posted to the pension fund and $237.8 million was posted to the insurance fund. Employees contributed $306.7 and $314.8 million between fiscal year 2003 to 2004, respectively. This decrease in the employee contribution was due to the decrease in voluntary service purchases. Investments fair value in investments was $1.14 billion for the end of fiscal year 2004. The pension fund realized losses of $155.2 million. Investment incomes net of investment expense was $298.2 million compared to $321 million in the previous fiscal year. Pension benefits for retirees and their beneficiaries increased by $100.2 million and totaled $849.2 million. There was also a refund of contributions to former members increased from $20.5 million to $23.4 million. (Rudolph, Comprehensive Annual Financial Report, 2004) The funding ratio continued to drop and was now 85.12% (Bluegrass Institute, 2018).

**Between 2005-2007**

The Commonwealth of Kentucky continued to grow in terms of personal income and employments between 2005 through 2007. However, the economic growth was not that substantial in 2007. In the beginning of 2005 personal income increased by 4.6% and continue to grow to about 5.6% in 2007. In 2005 through 2007, wages and salaries comprised about half of
total income. In 2005, the unemployment rate was 5.9 and was assumed to continue to grow by 1.3% in 2006 and 1.4% in 2007. In 2006 and 2007, the employment did have growth in sectors like nonfarm employment and service-providing. However, manufacturing employment was flat, with only minor gains.

See Appendix A for full classification of pension policy highlights between 2005 and 2006. In 2007, there was no enacted policy on the pension retirement system. Some of the most impacting policy passed between 2005 to 2006 were the following:

- In 2005: Kentucky. SB 267 reduced employer contribution rates for the State Employee Retirement System and the State Patrol system. Kentucky Retirement Systems estimates that the lost revenue will amount to a $213 million shortfall for the two systems over two years.

- In 2006: Kentucky. HB 380, the appropriations act, increased contribution rates for the Kentucky Employee Retirement System for both non-hazardous and hazardous employees and for the State Police Retirement Board, although not to the level requested by KERS on the basis of actuarial calculations.

Between 2005 through 2007, net assets of all pension funds continued to increase. For fiscal year 2004-2005, net assets were $525.6 million and continued to increase to $1,276.1 million by the end of fiscal year 2006-2007. Covered payroll also continued to grow from $4,160.4 to $4,484.4 million. The employer contribution totaled $390.2 million and increased by $48.1 million in fiscal year 2004-2005. By fiscal year 2006-2007, the employer contribution almost doubled. Employers now paid a total of $601.1 million. This amount was a $131.2 million dollar increase from the previous fiscal year. Employees contribution did see somewhat of a decline between 2005 to 2007. Investment income continued to grow as well. (Dean Borton Allen Ford, 2000-2016). Cash flow analysis determine that in both 2006 and 2007 the cash flow was negative in KERS-NH and SPRS (PRM Consulting Group, 2017). For KERS-H, CERS-NH, and CERS-H the cash flow was positive (PRM Consulting Group, 2017). Cash flow is
determined by looking at the inflows (employer and employee contributions, dividends, and interest) and subtracting outflows (benefit payments, administrative, and operating expenses). Again, the funding ratio continues to drop from 73.61% in 2005 to 56.89% in 2007 (Bluegrass Institute, 2018).

2008

This year marked the beginning of one of the worst economic recession since the Great Depression in 1929. The Commonwealth of Kentucky economy began to slowdown during this year. Income and employment growth began to lose momentum. In the beginning, the housing crisis had little impact on Kentucky because of limited exposure to the subprime market. However, mortgage related lending began to spread across all the states, in turn, making it difficult to obtain loans, and causing uncertainty in the financial markets. The outlook for Kentucky’s economy during this recession looked very bleak and was forecasted to negatively affect all aspects of its financial stability (Rudolph, Comprehensive Annual Financial Report, 2000-2016).

With that said, Kentucky began trying to address its funding issues for new members and retiree’s health benefits. It made extensive changes to the defined benefit plan for state and local employees. Key legislative actions included (to see a complete list of changes refer Appendix B):

- **HB 1:**
  
  - Requires that actuarial analyses display the effects of changes in law for a 20-year (rather than a 10 year) period; explicitly state each assumption used in the analysis; be done at the cost of the retirement systems.
  
  - Reduces COLAs in the Legislative Plan from CPI capped at 5% to 1.5% for current and future retirees; increases employee contributions for legislators joining the system after 9/1/08 from 5% to 6% of contributory base.
➢ For the state police plan and for employees of other plans in hazardous positions, who enter service 9/1/08 or later: reduces the multiplier for annual service from a flat 2.5% (2.49% in plans other than state police) to a scale that ranges from 1.3% for 10 years of service or less to 2.5% for those with 25 years or more. The applicable multiplier will affect all service.

➢ Establishes a sliding scale of multipliers for calculating benefits for state employees and county employees hired on or after 9/1/08, ranging from 1.1% for 10 years’ service or less to 2% for those with 30 years or service or more. Currently the multiplier is a flat 1.97% for state employees and 2% for county employees.

➢ Expresses the intent of the General Assembly to move gradually to annual full funding of the actuarial required employer contribution to the state retirement systems. Its intent is to provide 100% of the contribution for the State Police system by 2020, for other hazardous employees by 2019, and for the state employee system by 2025.

➢ For state, county and state police members hired after 9/1/2008, requires a 1% employee contribution (a new requirement) to the Insurance Trust Fund for medical benefits. Increases the vesting requirement for retiree medical benefits from 10 to 15 years and sets an eligibility for retirement medical benefits at the Rule of 87 or minimum age of 60 with 15 years of service. Annual medical benefit adjustment changed from CPI-U to 1.5%.

Kentucky Pension System combined plan nets assets from all funds decreased by $1,272.8 million during fiscal year 2018. The total covered payroll for this current year was $4,716.1 million. An increase of approximately $231.7 million. The total employer contribution was $722.7 million and had an increase of $121.6 million. Employees contribution totaled $304.3 million and $300.3 million, for 2008 and 2007, respectively. The increase in employee’s contribution was due to the increase in covered payroll and service purchased by employees. The net depreciation in the fair value of investments was -997.4 million. (Dean Borton Allen Ford, 2000-2016) Cash analysis shows that the all systems were negatively impacted and continue to slightly decrease. The funding ratio continued to drop and by 2008. It was now 52.50% (Bluegrass Institute, 2018).
From 2009 to current date, Kentucky continued to face impactful financial circumstances. The states economic growth has been better than its neighboring states (Herald Leader Editorial Board, 2018). However, it is lacking compared to the United States as a whole. A graph created by the Herald Leader best describes how Kentucky economy has been doing compared to the recovery of the United States since the recession in 2008.

Legislative actions were enacted to try and prevent an increase in the funding gap and recover from the enhancements made to the pension systems during the nineties. A few impactful legislations actions were (refer to Appendix A for complete legislative actions):

- **2012:** *Kentucky. 2012 Ky. Acts. Chap. 155* establishes the Kentucky Public Pensions Task Force to study issues regarding Kentucky's state-administered pension funds and to develop consensus recommendations concerning the benefits, investments, and funding of those funds. It is to report to the General Assembly by Dec. 7, 2012.

- **COLA-Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2)** with limited exceptions, eliminates any future COLAs for current and future retirees in the three plans administered by Kentucky Retirement Systems (KRS), the
Legislators’ Retirement Plan and Judicial Retirement Plan. Retirees may see a 1.5 percent COLA in only two scenarios: 1) the funding level of their plan is greater than 100 percent and subsequent legislation authorizes use of the surplus for COLA funding, or 2) the legislature appropriates sufficient funds to fully prefund the COLA in the year it is granted.

- **Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2)** requires employers to pay the actuarial costs associated with certain late-career compensation hikes for members of the State Police Retirement System (SPRS), Kentucky Employees Retirement System (KERS) and County Employees Retirement System (CERS) retiring on or after Jan. 1, 2014. The last participating employer must pay the full actuarial cost of annual increases in compensation greater than 10 percent during the last five fiscal years of employment. There is an exception for compensation increases stemming from a “bona fide promotion or career advancement.”

- **Defined Contribution, Cash Balance and Hybrid Plans- Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2)** provides for a cash balance plan for new members of the three plans administered by Kentucky Retirement Systems (KRS) and new members of the Legislators’ Retirement Plan and Judicial Retirement Plan.

Between 2009 through 2016, combined plan net assets continued to fluctuate. The largest decrease in net assets was witnessed at $10.9 billion dollars at the end of fiscal year 2016. Between 2009 through 2015, the increases and decreases were in the millions of dollars. Total contribution from employer and employee grew slowly from $685.5 million to $1,274.6 million by the end of 2016. However, between 2015 and 2016 the first decrease in contribution was witnessed. In 2015, the total contribution was $1,322.9 million. This change in contribution was caused by a decrease in the employer contribution for CERS-NH and CERS-H. The depreciation in the fair value of investments took multiple losses in years 2012, 2015, and 2016. Notably, in 2015, the investment profile net of expenses had a return of 2.01%, trailing behind 2014 net of expense return of 15.55%. By 2016, the investment portfolio reported net of expenses a return of -0.52%. (Dean Borton Allen Ford, 2000-2016) Cash analysis shows that all systems were now in
the negative. The funding ratio for the KERS-NH fell to 16.0% and 59.7% for the KERS-H (PRM Consulting Group, 2017).

C. Miscellaneous Information Effecting the Kentucky’s Pension System

Between 2005-2009, there were issues with investment returns not matching assumption that caused the unfunded pension liability to increase by $3.6 billion (PEW, 2013). In addition to the actuarial assumptions based on the workers demographics and salaries falling short and adding about $800 million in pension debt over this timeframe (PEW, 2013).

D. Observations

After reviewing legislative policies, economic data, and outcomes on the pension systems, the KERS was affected by multiple factors this includes: actuarial assumption changes, plan experience, investment market performance, investment plans performance, funding less than the
annual required contribution (ARC), and the cost of living adjustments (COLA). Since 2006, there has been significant red flags that should have alerted legislators and pension administrators that their defined benefit plan was not attainable for the number of retirees, members, and new hires. Two of the most important red flags were the funding ratios and the ongoing decline in cash flows. The Commonwealth should have made it a priority to fund the ARC.

Several policies had a negative impact on the pension system. The Commonwealth of Kentucky’s first mistake was retroactively enhancing the benefits in the nineties. These benefits were granted without taking into consideration a cost analysis and the monetary impact (Bluegrass Institute, 2018). The beginning of the 2000s, Kentucky legislators then enacted a change in computing final compensation from taking the average of the final five-years to taking the average of the final three-years. This would increase final compensation and increasing the pension benefits. In 2008, the new pension reform, including, increasing the employee retirement contribution by 1%, basing final compensation on high five-year salary, requiring the minimum retirement age to be 57, and reducing the pension benefits by basing them on years of service, was supposed to be a remedy the pension system’s funding gap, however the state still failed to make full payments (PEW, 2013).

Lastly, another policy that negatively affected Kentucky’s pension system, was the yearly mandated COLA adjustment. This cost was never paid and ultimately just continued to add cost to the unfunded pension liability. According to PEW, from 2006 through 2011 unfunded COLAS added $1.8 billion to Kentucky’s state and local pension debt (PEW, 2013). On the Kentucky Retirement Systems website, yearly increases were given to members since 7/1/1976 (Kentucky Retirement Systems, n.d.).
Policy that positively impacted the pension system would not be enacted until 2012-2013. In 2012, Kentucky established the Kentucky Public Pension Task Force. This task force would help the state’s retirement promises to be more affordable and sustainable. Following the task force, in 2013 the Commonwealth would now require all COLA adjustments be paid before they are given, and completely changed the type of plan it would offer to new hires. It would offer a cash-balance plan that would affect new hires after January 2014. Originally, the state had a defined-benefit (DB) plan that completely relied on the employer-sponsor to fund retirement benefits. This new cash-balance (CB), also referred to as a hybrid plan, would rely on both the employer and the employee to help fund their retirement. This new plan has aspects of both a traditional pension and an individual retirement account. This CB plan was designed to cost the same as the DB plan but allow them to be more flexibility when things did not go as expected.

According to PEW research, based on the retirements systems’ assumption, a 35-year-old hired by the state of Kentucky has a 57% chance of leaving before age 50. If that worker left at age 50 with 15 years of service, the CB plan would provide greater benefits than the old plan, a result of the more even accrual rate. A new worker who spends his/her full career in a public job will continue to receive a secure-somewhat smaller- benefit under this new plan.

Section III.

A. Best Practices Moving Forward

The Commonwealth of Kentucky has taken positive steps to help with positively affecting the pension system. First and foremost, Kentucky will need to require strong action to help reduce risk of continued increases in funding that impacts public spending and/or becomes unsustainable in the budget while keeping taxes at a competitive level, resort to the payment of benefits on a pay-as-you-go cash basis which could become fiscally unsustainable and plan insolvency, jeopardizing the retirement security thousands of former state and local government workers (PRM Consulting Group and Stites and Harbison PLLC, 2017). Next, the Commonwealth will need to adopt and maintain realistic actuarial assumptions. Most importantly, the state will need to have a more accurate investment returns assumption. It will need to be more consistent with the market experience across the past 10 years. Credit rating agency, Fitch Rating, has recommended for investment return rate to be 6% (PFM & PRM Consulting Group, 2017). In addition, it will need to focus on having more concise assumptions with payroll growth, life expectancy, and other demographics.

The new CB plan established in 2014, does have significantly less financial risk the previous DB plan. However, the CB plan is not completely protected from exposure to market risk. The Commonwealth bares the full risk that the guaranteed 4% rate of interest return will be achieved (PRM Consulting Group and Stites and Harbison PLLC, 2017). There is also a misconception that the “account balance” for the CB plan is actual dollars. However, it is a notional amount. The best recommendation moving forward would be to have new hires switch to a defined contribution plan. This will help to minimize the risk that pension funding crisis will continue to reoccur. It allows a mix of employer and employee contributions to grow over time
in an individual account that has a true representation of the dollar amount. It will also help to reduce actuarial risk. They will also need to determine an employer contribution that correlates to the income replacement ratio. According to PRM consulting group, the current amount of 6.2% of salary would provide a reasonable level of income replacement, which is between 80-85%.

My last recommendation would be to make sure the Commonwealth is fully funding the annual required contribution (ARC). ARC is an important barometer for states, like the Commonwealth of Kentucky, who are facing a pension crisis. ARC was developed in the 1990s by the National Association of State Retirement Administrators. It was recognized as the unofficial guideline for the amount of funding state and local governments need to contribute to their pension plans. A state or local government who has paid the ARC in full has made an appropriation to the pension trust to cover the benefits accrued that year and for any unfunded liabilities accumulated from previous years. If the assuming the actuarial valuation holds true, an allocation short of full ARC means that the unfunded liability will continue to grow and will require greater contributions for future years. Going forward, if the Commonwealth paid the ARC in full, it will alleviate the unfunded pension liability, while still covering the benefits in that current year.

B. Conclusion

The Commonwealth pension crisis is a direct result of bad policy and unpredicted economic downturns. Legislators will need to sustain fiscal discipline in order to achieve fully funding the Pension Retirement System. The 2013 pension reform was a step in the right direction. It helped to restore some fiscal health and has been predicted to improve the pension system by billions of dollars (PEW, 2013). The policies before 2013, has been and will continue to be detrimental to
the Pension Retirement System. Especially, if the Commonwealth does not have more realistic actuarial assumptions and fully fund the ARC. The future of the Pension Retirement System will need to continue to honor its commitments to state and local employees, while making sure those commitments are financially sustainable.
References


The PEW Chartiable Trust. (2013, September). *Kentucky’s Successful Public*. Retrieved from The PEW.
Appendix A

2001

The definition of final compensation was changed for employees of the Kentucky Employee Retirement System and the County Employee Retirement System to the three fiscal years with the highest average monthly salaries (changed from five years) for retirement between August 1, 2001 and January 1, 2009, with a minimum 27 years of service and with age plus years of service totaling at least 75. [This definition previously applied only to employees in hazardous occupations.] HB 278.

Kentucky. Cost of purchasing service credit was altered to 100 percent of the actuarial cost of the service, which will increase the cost of most types of purchase, as of July 1, 2001. This legislation replaces various purchase provisions with a common schedule. The change was made to balance the cost of a change in the definition of final average compensation. Kentucky Retirement System notes that most purchases would have increased in cost in any case because of the findings of a recent actuarial study and the shift from high-5 to high calculation of FAS for benefit calculations]. HB 278.

HB 309 created the Partial Lump Sum Option (PLSO) retirement benefit for members of the Kentucky Retirement Systems. A retiree may choose a lump-sum payment of 12, 24 or 36 times the monthly benefit, with or without a survivor’s option. Subsequent monthly benefit payments are reduced to reflect the impact of the lump-sum payment on the lifetime benefit of the retiree.

HB 309 authorized the Kentucky Retirement Systems to hire an adequate number of staff to make it more responsive to members’ needs. The Board may set a personnel classification and compensation system with benefits and protections comparable to those of the state personnel system.

HB 309 requires that employees be vested in the Kentucky Retirement Systems before purchasing most types of service credit, with the goal of reducing employer liabilities for insurance benefits by preventing short-term employees from purchasing large amounts of service credit. (source: H.B. 309 Actuarial Cost Analysis).

H.B. 309 also allowed vested members of the Kentucky Employee Retirement System and certain other state systems to purchase any amount of military service credit regardless whether the person is eligible for a military pension. Participating employees over the age of 65 with at least 15 years of service may purchase up to four years’ worth of active-duty service credit at 50 percent of the actuarial cost. All other purchases are at actuarial cost.

2002

HB 430 provides that employees hired July 1, 2003 or after will be required to earn at least 120 months of service credit before they will be eligible for insurance benefits at retirement. The percentage of the monthly insurance contribution paid for employees hired after July 1, 2003 is: 0-119 months, none; 120-179 months, 50%; 180-239 months, 75%; and 240 months or more, 100%. The 120-month service requirement will be waived if the employee is disabled in the line of duty or killed in the line of duty. The provisions of the bill also allow the General Assembly to alter the level of insurance benefits for employees hired after July 1, 2003.

Retired members and members with existing service credit in a Kentucky state retirement plan are unaffected by this legislation.

HB 461 provides that employees who retired and returned to work with a participating agency prior to August 1, 1998, may be eligible to purchase the period of reemployment, if the following conditions are met: Retirement from one of the retirement systems administered by the Kentucky Retirement System and re-employment before August 1, 1998 in a regular full-time position, earning less than the maximum permissible earnings under the Federal Social Security Act; participation in a second retirement account effective August 1, 1998; at least 48 months of service if age 65 or older, or at least 60 months of service if under age 65, in a second account in the systems administered by Kentucky Retirement Systems.

Kentucky tightened eligibility for future retiree health benefits through minimum service requirements.

2003

Chapter 121 (HB 434), section 12, establishes an Employer Medical Insurance Fund Stabilization Contribution. These state-funded employer contributions would be utilized to provide an adequate funding formula for the teachers’ retirement system’s medical insurance fund that provides medical insurance for eligible participants. The percentage to be National Conference of State Legislatures 17 contributed by the employer would be determined by the retirement system’s actuary for each biennial budget period. The retirement system actuary has determined the employer contribution to be 0.85% for fiscal year 2004-2005 and 1.87% for fiscal year 2005-2006. This amounts to $21,250,000 in fiscal year 2004-2005 and approximately $46,750,000 in fiscal year 2005-2006. No budget has been enacted for those fiscal years as of August 1st, 2004.

Chapter 121, Laws of 2004 (HB 434) provides that the Kentucky Teachers’ Retirement System may reduce a member’s retirement allowance on a dollar-for-dollar basis for each dollar that a retired member earns in employment exceeding 100 days or 12 teaching hours, and provide that the board shall adopt a methodology for a pro rata apportionment of days and hours for retired members who return to work in both teaching and non-teaching positions.

Benefits-Kentucky. HB 290 reduced the multiplier for members of the County Employee Retirement System from 2.25 to 2% for employees whose participation begins on or after August 1, 2004.

2004

Health Coverage Chapter 33, Laws of 2004 (HB 290), provides that state and county employee retiree health insurance shall not be considered as benefits protected by the inviolable contract provisions of the Kentucky Statutes. The General Assembly reserves the right to suspend or reduce retiree insurance benefits if in its judgment the welfare of the Commonwealth so demands. The law also provides that no employee hired after July 1, 2003, is entitled to retiree health benefits unless the employee has earned 120 months of service credit in a state retirement system. The benefit will be a monthly benefit of $10 for each year of service for employees not in hazardous duty, and $15 per year for those in hazardous duty. The amounts will be annually adjusted for inflation measured by the CPI up to 5% a year.
Kentucky set its state income tax exclusion for pensions at $41,110 for tax year 2006 and repealed its automatic annual adjustment of the exclusion based on the consumer price index.

Kentucky. SB 267 reduced employer contribution rates for the State Employee Retirement System and the State Patrol system. Kentucky Retirement Systems estimates that the lost revenue will amount to a $213 million shortfall for the two systems over two years.

Kentucky. HB 299 provides that an active legislator who was entitled to elect membership in the Legislators Retirement Plan (LRP) but who failed to do so within 30 days of taking office may elect to participate in LRP no later than August 31, 2005. If the legislator elects membership in LRP, participation in the Kentucky Employees Retirement System (KERS) will stop. Service earned as a legislator and credited to KERS may be transferred to LRP if the member pays the difference, if any, between the contributions and interest transferred from KERS and the actuarial cost of the transferred service.

Kentucky. HB 272 fixes the state income tax pension exclusion at $41,110 for tax year 2006 and thereafter. The exemption will no longer be subject to an annual adjustment based on the consumer price index. It applies to benefits earned after January 1, 1998.

Kentucky increased both employer and employee contribution rates for pension systems.

KENTUCKY. HB 380 of 2006, the appropriations act, increased contribution rates for the Kentucky Employee Retirement System for both non-hazardous and hazardous employees and for the State Police Retirement Board, although not to the level requested by KERS on the basis of actuarial calculations. The KERS request for non-hazardous employees was a contribution rate of 17.13% for FY 2007 and 20.15% for FY 2008. The General Assembly approved 7.75% and 8.5%, respectively. The enacted increases of 22% and 24.25% for hazardous employees are slightly below the request. Enacted increases of 25.5% and 28% for the Police Retirement Board compare with requests of 42.3% and 47.06%

KENTUCKY. Chapter 85, Acts of 2006 (HB 79) requires the Commonwealth of Kentucky to pay the member’s contribution to the Teachers Retirement System for all certified staff employed in local school districts who are members of a state national guard or reserve component ordered to active service by the president of the United States and who return to their former employment in a timely fashion upon release from active duty, so the member can receive service credit for the time spent in active duty.

Kentucky addressed funding issues for pensions and retiree health benefits for newly-hired general state and county employees, teachers and public safety officers in a massive piece of legislation enacted in special session. Generally, the legislation calls for somewhat higher ages of eligibility for retirement and health benefits, extends the period over which final average salary is calculated, and replaces single multipliers for calculating benefits with scales that provide a higher multiplier for retirees with longer periods of employment. It removes lump-sum payments at the termination of service from the base for calculating final average salary and restricts the use of accumulated sick leave for retirement eligibility and benefit calculation. It provides a more restrictive policy on benefits earned through a return to covered service after retirement. The legislation also establishes a schedule for the General Assembly to gradually full annual appropriation of the actuarially-required contributions for statewide retirement plans.

Retiree Health Benefits: Kentucky legislation added a 1% contribution requirement for general and law enforcement personnel, increased teachers' contribution by 1%, and increased vesting and eligibility requirements for post-retirement health benefits

KENTUCKY. HR 273 (adopted) urges the Kentucky Retirement Systems, the Kentucky Teachers' Retirement System, the Kentucky Judicial Form Retirement System, and the State Investment Commission to curtail future investments in companies doing business in Sudan.

HB 1 of the 2008 Special Session terminates the Partial Lump Sum Option for those who retire after 1/1/09.

Elected Officials Retirement Programs-KENTUCKY. HB 1 of the 2008 Special Session reduced the COLA for existing and future retirees from the Legislators' Retirement Plan from the CPI (capped at 5%) to 1.5%. It increased the employee contribution from 5% to 6% for legislators who begin office on or after September 1, 2008.

**SEE SUPPLEMENT**
2012

Ethics, Forfeiture of Benefits and Privacy-Kentucky. 2012 Ky. Acts, Chap. 75 (House Bill 300) requires the Kentucky Teachers’ Retirement System board of trustees to be subject to the executive branch code of ethics; requires placement agents who are involved with Kentucky Retirement Systems and Kentucky Teachers’ Retirement System investments to register as lobbyists and to define placement agents and unregulated placement agents; exempts placement agents from the contingent fee prohibition in the Executive Branch Code of Ethics; provides for public disclosure of expenditures.

Governance and Investment Policy-Kentucky. 2012 Ky. Acts, Chap. 75 (House Bill 300) requires the Kentucky Teachers’ Retirement System board of trustees to be subject to the executive branch code of ethics; requires placement agents who are involved with Kentucky Retirement Systems and Kentucky Teachers’ Retirement System investments to register as lobbyists and to define placement agents and unregulated placement agents; exempts placement agents from the contingent fee prohibition in the Executive Branch Code of Ethics; provides for public disclosure of expenditures.

Kentucky. 2012 Ky. Acts, Chap. 155 of 2012 (House Concurrent Resolution 162) establishes the Kentucky Public Pensions Task Force to study issues regarding Kentucky’s state-administered pension funds and to develop consensus recommendations concerning the benefits, investments, and funding of those funds. It is to report to the General Assembly by Dec. 7, 2012.

2013

Kentucky closed its defined benefit plan to new state and local employees hired on or after Jan. 1, 2014, and replaced it with a cash balance plan. The legislation commits the state to fully fund the public pension system beginning with the next biennial budget and eliminates cost of living increases, unless they are pre-funded, for current and future retirees.

COLA-Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2) with limited exceptions, eliminates any future COLAs for current and future retirees in the three plans administered by Kentucky Retirement Systems (KRS), the Legislators’ Retirement Plan and Judicial Retirement Plan. Retirees may see a 1.5 percent COLA in only two scenarios: 1) the funding level of their plan is greater than 100 percent and subsequent legislation authorizes use of the surplus for COLA funding, or 2) the legislature appropriates sufficient funds to fully fund the COLA in the year it is granted.

DB Plan Changes- Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2) requires employers to pay the actuarial costs associated with certain late-career compensation hikes for members of the State Police Retirement System (SPRS), Kentucky Employees Retirement System (KERS) and County Employees Retirement System (CERS) retiring on or after Jan. 1, 2014. The last participating employer must pay the full actuarial cost of annual increases in compensation greater than 10 percent during the last five fiscal years of employment. There is an exception for compensation increases stemming from a “bona fide promotion or career advancement.”

Defined Contribution, Cash Balance and Hybrid Plans-Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2) provides for a cash balance plan for new members of the three plans administered by Kentucky Retirement Systems (KRS) and new members of the Legislators’ Retirement Plan and Judicial Retirement Plan. Elimination of COLAs for current and future retirees is discussed in the Cost of Living Adjustments section of this report. New plan oversight provisions are discussed in the Governance and Investment Policy section of this report (SEE SUPPLEMENT).

2013 Continued

Ethics, Forfeiture of Benefits and Privacy-Kentucky. 2013 Ky. Acts, Chap. 43 (House Bill 63) permits trustees serving on the board of the Judicial Form Retirement System to accept de minimis compensation from people or businesses with whom they are involved in their official capacity as trustees. The Judicial Form Retirement System administers both the Judicial Retirement Plan and the Legislators’ Retirement Plan. Its trustees may receive an insignificant amount of compensation that does not raise reasonable questions about their objectivity and still remain on the board. If the amount is more than de minimis, the legislation requires disclosure and recusal from related matters. The legislation also clarifies that members or retirees of the system may serve as trustees, despite their interest in the board’s investments and other transactions.

Governance and Investment Policy-Kentucky. 2013 Ky. Acts, Chap. 120 (Senate Bill 2) establishes a Public Pension Oversight Board, modifies the composition of the Kentucky Retirement Systems (KRS) board and mandates full payment of actuarially required contributions for the three KRS plans. The legislation creates a Public Pension Oversight Board to assist the General Assembly with its review, analysis and oversight of KRS administration, benefits, investments and funding and to recommend law changes. The 13-member board is made up of six General Assembly members, two General Assembly appointees, two gubernatorial appointees, along with the following officials or their designees: the state budget director, the auditor of public accounts and the attorney general. The law contains expertise requirements for the legislative and gubernatorial appointees, who must possess 10 years of retirement experience or a CFA certification with at least 10 years of investment experience.

Senate Bill 2 also adds four new members to the KRS board of trustees. One additional trustee will be chosen by members of the County Employees Retirement System, and three trustees will be appointed by the governor based on recommendations from the Kentucky League of Cities, the Kentucky Association of Counties and the Kentucky School Board Association.

Finally, Senate Bill 2 resets the amortization period for full funding of the KRS plans to a new 30-year period beginning with 2013 actuarial valuations and requires to General Assembly to pay the full actuarially required contribution rate.
WEST VIRGINIA. Act 62 (SB 325) concerns the State Employee Deferred Compensation Plan and clarifies that an employee must have received pay every payday during a fiscal year to qualify for participation in the savings incentive matching program.

DEFINED BENEFIT PLAN CHANGES

ALASKA. Chapter 13 (SB 125) transforms the Public Employees' Retirement System's (PERS) defined benefit plan to a cost share plan, sets the employer contribution rate for PERS employers at 22% of PERS system payroll, provides for additional state contributions to the PERS system sufficient to make up the difference between 22% and the higher actuarially required rate, sets the Teachers' Retirement System (TRS) contribution rate at 12.56% of TRS payroll, provides for additional state contributions to the TRS system sufficient to make up the difference between 12.56% and the higher actuarially required rate, and provides for a past service rate surcharge on Defined Contribution Retiree (DCR) payrolls equal to the difference between the actuarial required contribution rate and the employer contribution rate established in this bill for both PERS and TRS consistent with language passed last session in SB 123.

GEORGIA. Act 757 (SB 328) creates the “Georgia State Employees’ Pension and Savings Plan” (GSEPS), which provides a hybrid defined benefit plan (DB) and 401(k) plan for new hires on and after January 1, 2009 and an opt in to members of ERS as of December 31, 2008. For details, see below, Defined Contribution and Hybrid Plans.

KENTUCKY. HB 1 of the 2008 Special Session made extensive changes to Kentucky state retirement plans for state and local employees including teachers, employees in hazardous positions and general employees. A section-by-section summary is available from the Kentucky Legislative Research Commission at 502-564-8100.

- Requires that actuarial analyses display the effects of changes in law for a 20 year (rather than a 10 year) period; explicitly state each assumption used in the analysis; be done at the cost of the retirement systems.
- Reduces COLAs in the Legislative Plan from CPI capped at 5% to 1.5% for current and future retirees; increases employee contributions for legislators joining the system after 9/1/08 from 5% to 6% of contributory base. Makes similar changes to the Judicial Retirement Plan.
- For the state police plan and for employees of other plans in hazardous positions, who enter service 9/1/08 or later: reduces the multiplier for annual service from a flat 2.5% (2.49% in plans other than state police) to a scale that ranges from 1.3% for 10 years of service or less to 2.5% for those with 25 years or more. The applicable multiplier will affect all service.
- Removes lump-sum compensation from the base used to calculate benefits and requires that the final high-3 must consist of complete fiscal years, each of 12 months. Regular retirement is set at 25 years of service or 60/5 (up from 20-and-out or 55/5). Purchased service may not be used for eligibility for a reduced benefit at 50/15. Actuary shall determine penalty for retiring with a reduced benefit. Caps use of sick leave for calculating benefits at 12 months (currently no cap) and prohibits use of accumulated sick leave for determining retirement eligibility. All these provisions affect only those hired on or after 9/1/08.
- For state employees hired on or after 9/1/08: Removes lump-sum compensation from calculation of final compensation; requires high-5 years to be the five 12-month fiscal years immediately preceding retirement (as opposed to 48 months in current law); limits use of sick leave as set out in previous paragraph; provides eligibility for normal retirement at 65/5.
or Rule of 87 with a minimum age of 57 or 60/10 (currently any age with 27 years or 65/4). Prohibits the use of purchased service in determining eligibility for benefits.

- Establishes a sliding scale of multipliers for calculating benefits for state employees and county employees hired on or after 9/1/08, ranging from 1.1% for 10 years service or less to 2% for those with 30 years or service or more. Currently the multiplier is a flat 1.97% for state employees and 2% for county employees.
- Caps the interest paid on members’ contributions when members withdraw early from a system at 2.5%. Presently it varies according to retirement board decisions, but cannot be less than 2.5% for state police, or less than 2% for state employees.
- Makes changes to the County Employee Retirement System that are generally comparable to those for state employees.
- Expresses the intent of the General Assembly to move gradually to annual full funding of the actuarial required employer contribution to the state retirement systems. Its intent is to provide 100% of the contribution for the State Police system by 2020, for other hazardous employees by 2019, and for the state employee system by 2025.
- Terminates the Partial Lump Sum Option for those who retire after 1/1/09.
- For state, county and state police system members, requires a 3-month break in service before returning to covered employment (with exceptions for hazardous employees). No employee can earn a second benefit. Employers must resume employer contributions for retirement and health insurance for re-employed members.
- For state, county and state police members hired after 9/1/2008, requires a 1% employee contribution (a new requirement) to the Insurance Trust Fund for medical benefits. Increases the vesting requirement for retiree medical benefits from 10 to 15 years and sets an eligibility for retirement medical benefits at the Rule of 87 or minimum age of 60 with 15 years of service. Annual medical benefit adjustment changed from CPI-U to 1.5%.
- For teachers and school employees hired on or after 7/1/08: Changes are generally comparable in intent to those for state employees. Limits sick leave used for retirement purposes to 100 days. Remove lump-sum compensatory and termination payments from computation of final average salary. Sets interest on member accounts for purpose of withdrawal at 2.5%, down from existing 3%. Provides that FMLA leave must be purchased at full actuarial cost. Prohibits purchase of air time except for employees with more than 26 years service to purchase up to 10 months to make up full retirement eligibility. Increases requirement for reduced early benefit from 5 to 10 years of service and sets the annual penalty at 1% for each years short of 27 years or age 60. Changes multipliers for public school and university faculty from flat rates to a scale based upon length of service, for public schools from 1.7% to 3% for years over 30, and for faculty from 1.5% to 2% for years over 27 (multipliers are reduced from previous law for shorter periods of service). Allows teachers returning to service after retirement to waive their retirement benefit and have it recalculated on the basis of additional service upon termination of the reemployment. Increases vesting for medical benefits to 15 years and increase the employee contribution by 1 percentage point.
- For the Ken. Ret. System and the Teachers Ret. Sys. Boards of trustees, limits elected trustees to 3 terms, applicable to terms beginning after July 1, 2008. Establishes formal trustee education programs, provides for enforcement, and establishes various board reporting requirements.

**NEBRASKA.** LB 1147 of 2008 (enacted) provides for an early retirement provision for members of the Judicial Retirement Plan.

**WYOMING.** Chapter 21, Laws of 2008 (SF 68), made changes to the Judicial Pension Plan. This bill changes the required employer contribution for judicial retirement from 8.78% to 14.5%. For the...
DROP AND LUMP-SUM WITHDRAWALS

INDIANA. Chapter 115, Laws of 2008 (SB 72), allows a member of the Public Employees' Retirement Fund who is vested, separates from employment does not perform service in a covered position for at least 90 days, and is not eligible at separation to receive a retirement benefit; to elect to withdraw the entire amount in the member's annuity savings account.

KENTUCKY. HB 1 of the 2008 Special Session terminates the Partial Lump Sum Option for those who retire after 1/1/09.

EARLY RETIREMENT INCENTIVES

NEW JERSEY. Chapter 21, Laws of 2008 (A 2802/S 2044), provides additional retirement benefits to certain employees of state government; provides for an early retirement incentive program which includes additional compensation and health benefits; regulates the purchase of service credit to qualify for the program; allows a retired employee to be reemployed for emergency management purposes; limits the number of employees hired thereafter to fill vacancies created to ten percent of those employees who retired.

The intent of the legislation is to induce around 2,100 employees to retire in addition to the 1,000 who could usually be expected to do so. The policy goal is to reduce the state workforce so as to save about $90 million in compensation a year.

The act provides additional service credit to employees who are 58 or old with at least 25 years of service, so as to increase their retirement benefit by 5.45% (and somewhat higher for veterans). Employees who are 60 or older with 20 to 25 years of service will be eligible for post-retirement health benefits. Those who are 60 or older with at least 10 but less than 20 years of service are offered $12,000 paid over 24 months, not an pension benefit increase. Eligible employees may not purchase additional service credit after the effective date of the act and cannot return to executive branch employment for three years. Judicial employees may not return to judicial branch employment for three years. Employers have the power to require an eligible employee to delay retirement for one year. [The Philadelphia Inquirer reported on July 30 that about 1,500 New Jersey employees had accepted the offer, which closed on July 15, according to preliminary figures.]

TENNESSEE. The Tennessee state executive branch has offered a voluntary buy-out program to approximately 12,000 full time career employees with a goal of winning about 2,000 voluntary separations from state government to avoid firings. This is not an early retirement program in the sense of providing additional service credits to induce employees to begin retirement benefits. The goal is to reduce recurring state expenditures by about $64 million a year. The program offers these inducements:

- Four months of base salary at the greater of the rate of pay in effect on June 2, 2008, or the employee’s voluntary separation date, plus $500 for every year of state service through the employee’s voluntary separation date (partial years are rounded up).
- Advanced payment of the next scheduled longevity payment, calculated according to normal State practice, as long as the payment accrues on or before June 30, 2009.
- Normal payment of accrued, unused annual leave and compensatory time.
- Continuation of subsidized medical care coverage for the first six months of COBRA medical coverage, should the employee be eligible and elect to participate in COBRA. After
that, participants will be responsible for the full COBRA premium for up to 12 additional months.

- Participants 65 years of age and older as of their voluntary separation date will receive a one-time $2,400 cash payment to assist in the transition to Medicare.
- Tuition assistance of up to $10,800 ($5,400 per year) at the schools, institutions and entities governed by the Tennessee Board of Regents and the University of Tennessee Board of Trustees, as well as state certified apprenticeship.

This program was authorized in the 2008 General Appropriations bill, §60, item 1, Chap 1203, Laws of 2008. Sources: Fiscal Review Office, June 18, 2008, Tennessee Department of Human Resources. [On July 30, Governor Phil Bredesen of Tennessee said that the buy-out program is unlikely to reach the goal of eliminating 2,200 positions. Of about 1,600 applications, 1,200 appeared to be acceptable since they were positions the executive branch could eliminate. The governor suggested that the program might be offered to people who were not included in the original offer.]

**Elected Officials’ Retirement Programs**

**Kentucky.** HB 1 of the 2008 Special Session reduced the COLA for existing and future retirees from the Legislators’ Retirement Plan from the CPI (capped at 5%) to 1.5%. It increased the employee contribution from 5% to 6% for legislators who begin office on or after September 1, 2008.

**Hawaii.** Act 47 (SB 3005) repeals the provisions that (1) make Employee Retirement System membership by elective officers optional and (2) allow elective officers and judges to withdraw from ERS membership by nominally retiring even though they remain in office. It replaces those provisions with a new section to provide that an elective officer shall be a member of the employee's retirement system when elected for the first time (or, in the case of existing office holders, by October 1, 2008), unless the elective officer exercises a one-time irrevocable election to be excluded from membership in the employees' retirement system. This Act also sets forth the requirements that must be satisfied for retirants to return to service as elective officers without suspension of retirement benefits.

This act also repeals the statutory provision that allows elective officers and judges who have reached the statutory cap on retirement benefits to withdraw from membership in the employees' retirement system by nominally retiring even though they remain in office.

**Oklahoma.** Chapter 105, Laws of 2008 (SB 1641) provides that for people elected to office on or after July 1, 2008, the previous-law provisions for elected officials contributions and benefit calculation can apply only to years of service as an elected official and can be based only on the higher year of salary received as an elected official (not on any subsequent salary from a non-elective post as was possible under the original provisions). Capped benefits at 100% of salary as a member of the Oklahoma Public Employee Retirement system (not clear whether this is highest salary as an elected official). [Law responds to concerns that the old formula could provide what some considered an unduly generous benefit for former elected officials who occupied highly-compensated public positions after service as an elected official.]

**Utah.** Chapter 335, Laws of 2008 (HB 202) modifies the State Retirement and Insurance Benefit Act so far as it concerns at-will employees and elected officials. The act allows the transfer of a member's defined benefit plan balance to a defined contribution plan, by adding certain employees who may elect to be excluded from membership in the public employees retirement systems; allows certain elected and appointed executives and senior staff to elect to have defined benefit balances
retirement benefits because full distribution has occurred; provides for termination of retirement benefits in public retirement plans of those who have rendered less than honorable service; provides for retention of employer contributions for members of the Teachers' Defined Contribution Retirement System whose benefits are terminated for less than honorable service.

GOVERNANCE AND INVESTMENT POLICY

ALABAMA. Chapter 282, Laws of 2008, (HB 467) provides that active state employees who are candidates for the Board of Control would be elected in a statewide ballot conducted by the Secretary Treasurer as are the retired state employees.

COLORADO. HB 1403 (enacted) updates the statutory framework for allowing Denver Public Schools (DPS) as an employer to become affiliated with the Public Employees Retirement Association (PERA) and for the Denver Public Schools Retirement System (DPSRS) to be merged with PERA. The bill makes any such merger effective January 1, 2009, or later if agreed to by the parties. The bill prohibits any subsidy by or between the affected entities.

Upon merging, all assets and liabilities of DPSRS become assets and liabilities of PERA. Each entity must bear all of its own costs in relation to the merger, except costs for the actuarial valuation will be shared among the parties and DPS is responsible for obtaining a ruling and determination from the federal Internal Revenue Service related to the merger.

The bill specifies that no member from DPSRS shall have their entitlement to retirement benefits involuntarily reduced. It also specifies that details of the merger be implemented through an agreement specifying, among other things, rules about portability, the effect of any post-signing litigation on the merger, and material adverse changes that may allow a party to terminate the merger prior to the effective date. The parties are directed to negotiate a separate agreement to address health care coverage for retirees, beneficiaries, and members of the merging system.

KENTUCKY. HB 1 of the 2008 Special Session limits elected trustees of the Kentucky Retirement System and the Teachers Retirement System to 3 terms, applicable to terms beginning after July 1, 2008, and establishes formal trustee education programs, provides for enforcement, and establishes various board reporting requirements.

The act also expresses the intent of the General Assembly to move gradually to annual full funding of the actuarial required employer contribution to the state retirement systems. Its intent is to provide 100% of the contribution for the State Police system by 2020, for other hazardous employees by 2019, and for the state employee system by 2025.

MARYLAND. Senate Bill 606/House Bill 1277 require the State Retirement and Pension System, among other State agencies, to attempt to use minority business enterprise (MBE) investment management and brokerage firms to the greatest extent feasible and consistent with its fiduciary responsibilities.

Chapter 506, Laws of 2008 (Senate Bill 384/House Bill 481) make several changes to law governing the investment of the pension trust fund. First, they repeal a 1.2 percent cap on fees paid to external managers who provide real estate and alternative investment management services. A 0.3 percent cap on fees paid to all other external asset managers remains in effect. Second, the bills repeal a requirement that all real estate transactions carried out by the Board of Trustees be approved by the Board of Public Works. Instead, those transactions must be approved by a majority of the Comptroller, Treasurer, and the Secretary of Budget and Management in their capacity as members.
of the Board of Trustees. Finally, the bills repeal archaic language limiting the board’s investments in nondividend paying common stocks to 25 percent of the system’s assets. That limitation has been rendered obsolete by the board’s adherence to modern portfolio theory and the prudent investor standard.

**NEW HAMPSHIRE.** Chapter 300, Laws of 2008 (HB 1645) require that new or reappointed members of the Board of Trustees have familiarity with or experience in finance or business management redefines and makes more explicit the fiduciary responsibilities of the members of the board and their investment and reporting responsibilities.

**TENNESSEE.** Chapter 670, Laws of 2008 (SB 2654) Concerns Pensions and Retirement Benefits; provides that the retired teacher appointed to the Consolidated Retirement System Board of Trustees shall be a voting member.

Chapter 674 (SB 3276) increases the percentage of Tennessee Consolidated Retirement System assets that may be invested in real property from 5 percent to 10 percent.

**UTAH.** Chapter 252, Laws of 2008 (SB 116), changes the schedule on which the executive director of the Utah Retirement System carries out actuarial reviews of the system’s finances and demographic experience from every two years to every three years.

**WISCONSIN.** Chapter 212, Laws of 2008 (Assembly bill 623) authorizes the State Investment Board to manage the money and property of the core retirement investment trust and the variable retirement investment trust, which together make up the public employee trust fund, in any manner that does not violate State Investment Board’s standard of responsibility; establishes, however, that the State Investment Board’s must continue to invest assets of the variable trust primarily in equity securities.

**WYOMING.** Chapter 79, Laws of 2008 (SF 9), provides that individual board members of any public employee retirement system are liable under the Uniform Management of Public Employee Retirement Systems Act only for willful misconduct, intentional torts or illegal acts.

**HEALTH COVERAGE**

**KENTUCKY.** HB 1 of the 2008 Special Session requires state, county and state police members hired after 9/1/2008, to make a 1% employee contribution (a new requirement) to the Insurance Trust Fund for medical benefits. Increases the vesting requirement for retiree medical benefits from 10 to 15 years and sets an eligibility for retirement medical benefits at the Rule of 87 or minimum age of 60 with 15 years of service. The annual medical benefit adjustment was changed from CPI-U to 1.5%. Teachers’ contribution was increased by one percentage point and their vesting for medical benefits was also increased to 15 years.

**NEW HAMPSHIRE.** Chapter 300, Laws of 2008 (HB 1645) provides that the medical subsidy will not be increased until July 1, 2012, when it will be increased by 4% Provides for an equal increase on each subsequent July 1. Ends the practice of funding medical benefits from the Special Account (used for cost-of-living adjustments) and transfers $250 million from the Special Account to the retirement trust fund. Provides a new fund for retiree health benefits and sets employer contributions at 25% of salary or the amount the actuary deems necessary, whichever is less. Creates a commission to propose a retiree health care benefits funding model.
Chapter 76 (SB 51) reduces the waiting period after which a retired member of the state teachers' retirement fund or the public employees retirement fund may be reemployed in a covered position and continue to receive a retirement benefit.

KENTUCKY. HB 470 (signed into law) allows un-purchased out-of-state K-12 public school service to count toward the thirty years required to return to work at 75% of last annual compensation as opposed to 65%.

HB 1 of the 2008 Special Session requires state, county and state police system members to have a 3-month break in service before returning to covered employment (with exceptions for hazardous employees). No employee can earn a second benefit. Employers must resume employer contributions for retirement and health insurance for re-employed members. Teachers who return to service after retirement may waive their retirement benefit and have it recalculated on the basis of the additional service upon termination of the re-employment.

MARYLAND. Senate Bill 564/House Bill 720 (both passed) were sponsored by the Joint Committee on Pensions to address several issues related to the reemployment of State Retirement and Pension System retirees. First, they allow State judges receiving vested or normal service retirement benefits from either the Employees’ Retirement System (ERS) or the Employees’ Pension System (EPS) to suspend those benefits and earn credit in the Judges’ Retirement System (JRS). This allows a judge to earn credit in the JRS while ensuring that the judge’s spouse will receive survivor benefits from ERS/EPS should the judge die while serving on the bench. The bills also exempt a JRS retiree who is also receiving a service retirement benefit from ERS/EPS from an earnings limitation if the JRS retiree is temporarily assigned to serve on a State court. The bills require local school systems to reimburse the State Retirement and Pension System for the offset of pension benefits for retired teachers rehired by their former employers that result from late or nonreporting of reemployed retirees who are exempt from the offset. Finally, the bills require the Joint Committee on Pensions to study issues related to the reemployment of State retirees and submit a report to the General Assembly by December 31, 2008.

NEW YORK. Chapter 640, Laws of 2008, prohibits retirees from returning to work under Section 211 of the Retirement and Social Security Code in the same or a similar position for a period of one year following retirement. Significantly, the new law does not apply to individuals who already have received such approvals. Earnings from work for a former employer are subject to a set limit—the difference between the Single Life Allowance (Option 0) amount and your final salary. A "former employer" is any public employer that paid you a salary during the two years before your retirement and your retirement benefit is based in part on that salary and/or service.

SERVICE CREDIT/PURCHASE OF SERVICE

IOWA. Senate File 2424, §52 (enacted), allows members of the Iowa Public Employee Retirement system to buy up to five years of service credit that is not tied to specific employment (air time) and allows members of the Municipal Fire and Police system to purchase service credit for military service at the actuarial cost of the service.

KENTUCKY. HB 1 of the 2008 Special Session prohibits purchase of air time in the Teachers Retirement System except for employees with more than 26 years service to purchase up to 10 months to make up full retirement eligibility. For state employees, the act prohibits the use of purchased service in determining eligibility for benefits.
### Appendix C

**Kentucky’s Pension Challenge**

Pension funding levels by plan, 2012

<table>
<thead>
<tr>
<th>Plan</th>
<th>Assets*</th>
<th>Liabilities*</th>
<th>Unfunded Liability*</th>
<th>Percent Funded</th>
<th>Share of Total Shortfall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kentucky Employees Retirement System—Nonhazardous</td>
<td>$3,101</td>
<td>$11,361</td>
<td>$8,260</td>
<td>27%</td>
<td>32%</td>
</tr>
<tr>
<td>Kentucky Employees Retirement System—Hazardous</td>
<td>$497</td>
<td>$753</td>
<td>$255</td>
<td>66%</td>
<td>1%</td>
</tr>
<tr>
<td>County Employees Retirement System—Nonhazardous</td>
<td>$5,547</td>
<td>$9,140</td>
<td>$3,592</td>
<td>61%</td>
<td>14%</td>
</tr>
<tr>
<td>County Employees Retirement System—Hazardous</td>
<td>$1,747</td>
<td>$3,010</td>
<td>$1,263</td>
<td>58%</td>
<td>5%</td>
</tr>
<tr>
<td>State Police Retirement System</td>
<td>$260</td>
<td>$648</td>
<td>$388</td>
<td>40%</td>
<td>1%</td>
</tr>
<tr>
<td>Judicial Retirement Fund</td>
<td>$177</td>
<td>$317</td>
<td>$141</td>
<td>56%</td>
<td>1%</td>
</tr>
<tr>
<td>Legislators’ Retirement Fund</td>
<td>$39</td>
<td>$68</td>
<td>$29</td>
<td>57%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Kentucky Teachers’ Retirement System</td>
<td>$14,691</td>
<td>$26,974</td>
<td>$12,282</td>
<td>54%</td>
<td>47%</td>
</tr>
<tr>
<td><strong>Subtotals of All Plans Except Teachers</strong>*</td>
<td>$11,369</td>
<td>$25,297</td>
<td>$13,928</td>
<td>45%</td>
<td>53%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$26,060</td>
<td>$52,271</td>
<td>$26,210</td>
<td>50%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Numbers are in millions.

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