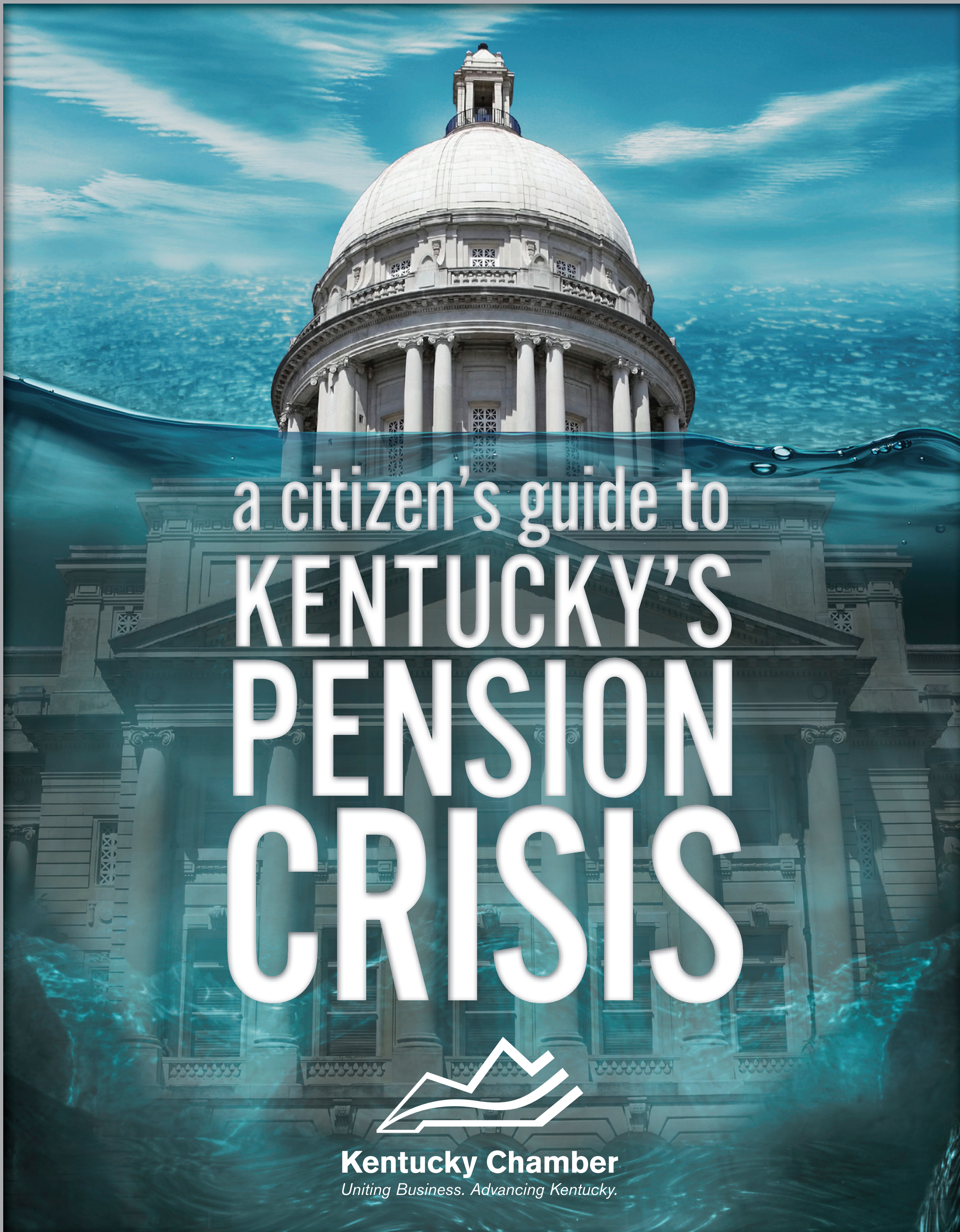


a citizen's guide to KENTUCKY'S PENSION CRISIS

Kentucky Chamber

Uniting Business. Advancing Kentucky.

If all 4.3 million Kentuckians were asked to pitch in to fix the $36 billion pension deficit, it would take $8,268 from every man, woman and child in the Commonwealth.

An impact on all Kentuckians

Kentucky is drowning in a financial crisis. With UNFUNDED LIABILITIES totaling more than $36 billion in 2015, Kentucky's public pension systems are among the worst funded in the United States. This financial crisis threatens the retirement security of state and local government employees and teachers. But it also has a critical – and negative – effect on all Kentucky taxpayers:

The underfunding has prompted national agencies to downgrade Kentucky's CREDIT RATING, meaning it costs taxpayers more to build roads, schools and other important projects that serve the public.

The public pension situation is complex and confusing. But having a clear understanding of the challenge it represents is vital if Kentucky is to find a way out of this crisis that threatens its financial future. Providing information that enables such an understanding is the purpose of this issue brief, which:

- provides background data on Kentucky's major pension systems
- reviews how Kentucky's pension systems got into such poor shape
- compares Kentucky's performance with national averages
- summarizes recent reforms in the system
- outlines recommendations for moving forward and putting our pension systems on a sound financial track

PENSION TERMS DEFINED

UNFUNDED LIABILITY

The difference between the total value of pension benefits owed to current and retired employees or dependents based on past years of service and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.

STATE CREDIT RATING

Ratings assigned by bond rating agencies that reflect a state's ability to pay debts and the general health of the state's economy. A higher credit rating generally indicates lower interest costs (and lower costs to taxpayers) on bonds issued by states to finance public projects.

EDITOR'S NOTE:

Throughout this document, all terms in GREEN CAPITALS are defined in the gray margin.

PENSION TERMS DEFINED

DEFINED BENEFIT

A retirement plan that promises its recipients a set level of benefits, generally for life. In the case of pensions, the benefit is based on a formula that usually includes the number of years served and an employee's salary multiplied by a preset figure or retirement factor (for example, 30 years x $40,000 x 1.75%).

KENTUCKY RETIREMENT SYSTEM

Also known as KRS, it is the state agency that administers KERS, CERS and the State Police Retirement System.

COUNTY EMPLOYEES RETIREMENT SYSTEM

Also known as CERS, this retirement plan covers 92,157 active and 54,904 retired hazardous and non-hazardous duty employees of city and county governments, local police and firefighters, non-teaching employees of local school boards, circuit clerks and local library employees.

HAZARDOUS AND NON-HAZARDOUS

Hazardous duty employees include police, fire, emergency medical services and corrections employees. All other employees are classified as non-hazardous.

STATE POLICE RETIREMENT SYSTEM

The retirement plan that covers 940 active and 1,324 retired state troopers.

KENTUCKY TEACHERS' RETIREMENT SYSTEM

Also known as KTRS, this retirement plan covers 77,246 active and 49,822 retired teachers in local school districts and employees of community colleges and some state universities.

Defining the pension problem

The Commonwealth of Kentucky operates two main DEFINED BENEFIT pension systems that provide retirement benefits to public employees.

- The KENTUCKY RETIREMENT SYSTEM (KRS) includes five different funds:
  - Two funds within the KENTUCKY EMPLOYEES RETIREMENT SYSTEM, covering state government employees who work in hazardous and non-hazardous occupations
  - Two funds within the COUNTY EMPLOYEES RETIREMENT SYSTEM, covering city and county government employees who work in HAZARDOUS & NON-HAZARDOUS occupations
  - The STATE POLICE RETIREMENT SYSTEM, covering state troopers
- The KENTUCKY TEACHERS' RETIREMENT SYSTEM covers teachers and some university and community college employees.

Pension benefits paid to public employees are based on a calculation involving three factors set by state law: an employee's final salary, which is generally based on the average of the highest five years of salary; the benefit factor, a percentage based on the amount of service and dates of employment; and length of service, which includes time actually worked, prior service, purchased service and sick leave. In 2015, the average pension benefit for retired employees with 25 to 30 years of service (the largest category of retirees) was $27,528 a year for state government employees in a non-hazardous position and $46,766 a year for KTRS retirees (which include teachers, administrators and some university employees).

Why not reduce benefits?

State law protects retirement benefits for state employees hired before January 1, 2014, under the INVIOLABLE CONTRACT, with the law stating that pension benefits "shall not be subject to reduction or impairment by alteration, amendment, or repeal." Teachers' retirement benefits are afforded similar protection, although certain benefits provided to retired teachers (such as health insurance and use of sick leave in calculating benefits) are not covered. It should be noted that the restrictions imposed by the inviolable contract are not fully clear. The General Assembly has not enacted legislation to reduce retirement benefits for current employees or retirees so there has been no legal challenge under the statute.

Kentucky's retirement systems are funded by employers and employees, both of whom contribute a percentage of the employee's wages to the retirement system each pay period. The retirement systems invest these contributions (in the stock market and elsewhere) and use the investment income to fund retirement benefits. The amount paid by employees is set by state law. Experts for the pension plan annually determine the ARC, or ACTUARIALLY REQUIRED CONTRIBUTION, that should be paid by state and local governments to ensure contributions are adequate to fund the system. The actual amount that is paid to the Kentucky Employees Retirement System and the Kentucky Teacher's Retirement System is determined by the General Assembly as part of the state's BIENNIAL BUDGET. Local governments pay the full required contribution to the County Employee Retirement System as they have no ability to pay a lower amount.

PENSION TERMS DEFINED

INVIOLABLE CONTRACT

State laws that provide Kentucky's pension benefits are a contractual right and stipulate that those benefits may not be reduced or terminated by the legislature retrospectively.

ACTUARIALLY REQUIRED CONTRIBUTION

Also known as the ARC, this is the amount of money actuaries calculate that an employer needs to pay into a retirement plan each year to fully fund benefits. The ARC reflects the cost of benefits that will be paid to employees and additional funding that will enable the government to reduce the unfunded liabilities of the past.

BIENNIAL BUDGET

The biennial budget, adopted every two years by the General Assembly, is Kentucky's financial plan for spending money on programs and services. The budget appropriates money by fund type. These include the General Fund, the bulk of the state's revenue generated by income, sales and other taxes; the Road Fund, financed by the gas tax and the sales tax on automobiles; restricted funds, money that state agencies generate through license fees, tuition and other charges; and federal funds.

KEY FACTS & FIGURES

	Active Employees	Retired Employees	Annual Benefit Payments	Total Actuarial Unfunded Liabilites	Funded Ratio
KERS Nonhazardous Pension Fund	39,289	38,827	$905,790,000	$10,008,682,909	19.0%
KERS Nonhazardous Insurance Fund			$125,272,000	$1,718,686,990	28.8%
KERS Hazardous Pension Fund	3,932	2,575	$56,774,000	$338,745,630	62.2%
KERS Hazardous Insurance Fund			$17,000,000	-$76,606,957	120.4%
CERS Nonhazardous Pension Fund	82,969	48,515	$615,335,000	$4,265,476,908	60.3%
CERS Nonhazardous Insurance Fund			$113,734,000	$910,370,377	68.7%
CERS Hazardous Pension Fund	9,188	6,389	$200,134,000	$1,516,524,591	58.0%
CERS Hazardous Insurance Fund			$65,553,000	$416,308,115	72.3%
State Police Pension Fund	940	1,324	$54,766,000	$485,768,500	33.8%
State Police Insurance Fund			$13,483,000	$87,036,770	65.8%
KTRS Pension Fund	77,246	49,822	$1,741,456,095	$13,930,442,000	55.3%
KTRS Insurance Fund			$240,400,000	$2,887,745,000	18.1%
TOTALS	213,564	147,452	$3,243,507,095	$36,489,180,833	

THE BASICS

KENTUCKY EMPLOYEES RETIREMENT SYSTEM

- $10 billion in unfunded liabilities
- 19% funded

KENTUCKY TEACHERS' RETIREMENT SYSTEM

- $13.9 billion in unfunded liabilities
- 55.3% funded

Source: 2015 Comprehensive Annual Financial Reports, KTRS and KRS

A pension fund is considered to have unfunded liabilities or pension debt if the fund does not have sufficient assets to pay the present and future liabilities of promised benefits. The funded ratio of a pension plan represents the value of assets in the plan divided by the pension obligation. For example, a funded ratio of 50 percent means a plan only has half the money needed to pay its outstanding liabilities.

The chart above shows key data for each of the main retirement funds, including unfunded liabilities and funded ratio. The data include annual health insurance payments under the retirement funds, which are part of the unfunded liabilities calculations.

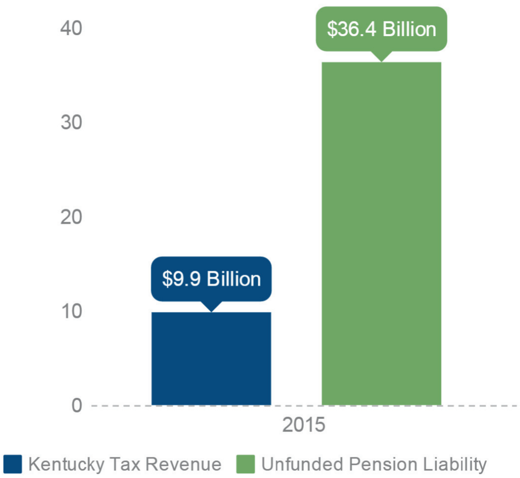
How bad is it?

A July 2015 report by the Pew Charitable Trusts compared state pension funding levels for all 50 states. (The Public Sector Retirement Systems Project at Pew annually tracks state pension funding and has advised the Kentucky General Assembly on pension reform.) Kentucky ranked 49 out of 50 states—only Illinois ranked lower. The report found the national average state pension funding level to be 71.8%. Kentucky's combined funding level for all its systems was only 44.2%.

To put this in a different perspective: Kentucky's total unfunded pension liability of $36.4 billion in FY 2015 was more than three and a half times the total General Fund tax revenue the state collected in that entire year.

Considered another way, the $36.4 billion in 2015 pension debt amounted to $8,268 for every man, woman and child in the Commonwealth. And it was equal to 19.3% of Kentucky's entire gross domestic product (all state economic activity) in 2014. Clearly, this level of debt is not sustainable in a state with a 46th-place ranking in income and 18 percent of its population living below the poverty level.

Kentucky Tax Revenue vs. Unfunded Pension Liability, 2015



And while the condition of the state's different pension plans varies somewhat, those covering both state employees and teachers are projected either to have insufficient ASSETS to pay promised benefits or to be forced into an all-cash basis to pay benefits due to the depletion of investment assets.

To provide full funding for the retirement systems in the next fiscal year will require more than $580 million on top of the $990.3 million in state funds currently appropriated for pensions in the FY 2016 budget, according to the Office of State Budget Director.

THE BASICS

ILLINOIS IS THE ONLY STATE RANKED LOWER THAN KENTUCKY ON PENSION FUNDING.

According to a report by the Pew Charitable Trusts, Kentucky ranked 49th out of 50 states on pension funding levels. Only Illinois ranked lower.

A downgrade of Illinois' credit rating due to pension liabilities increased the cost of a $1.3 billion bond issue for construction projects in that state by $95 million over the term of the bonds.

This increased cost was enough to fund the construction of at least four high schools or 12 elementary schools.

Chart Source: 2016-18 Preliminary Consensus Forecasting Group Revenue Estimates and 2015 Comprehensive Annual Financial Reports, KTRS and KRS

PENSION TERMS DEFINED

ASSETS

The amount of money a pension fund has on hand to fund benefits. The assets accumulate over time, generally from three sources: employee payments, employer payments and investment returns. The assets generally are spent to pay pension benefits, to refund the contributions of people who leave the plan before qualifying for benefits and to cover the plan's administrative expenses.

PENSION TERMS DEFINED

ACTUARY

An actuary is a business professional who analyzes the financial consequences of risk. To ensure the financial viability of insurance and retirement plans, actuaries use mathematics, statistics and financial theory to model demographic trends and economic activity to set insurance premiums and pension contribution rates.

ASSUMPTIONS

Actuaries' estimates about future trends of economic and demographic factors that will affect how much will be paid in pension benefits over time. The factors include such things as investment returns, inflation rates and how long retirees will live; actuaries use them to calculate the actuarily required contribution.

Chart Source: The Pew Charitable Trusts, 2013

COLA

An abbreviation for Cost of Living Adjustment — an annual increase in pension benefits to reflect a higher cost of living. At present, KRS retirees do not receive a COLA while retired teachers do.

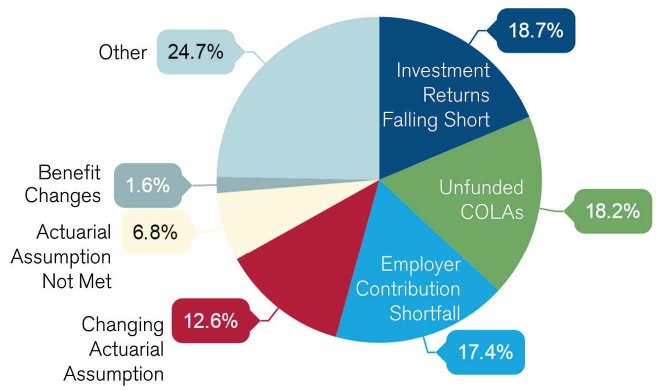
Chart Source: Pension Trust Advisor's Presentation to the KTRS Funding Work Group, 2015

How did this happen?

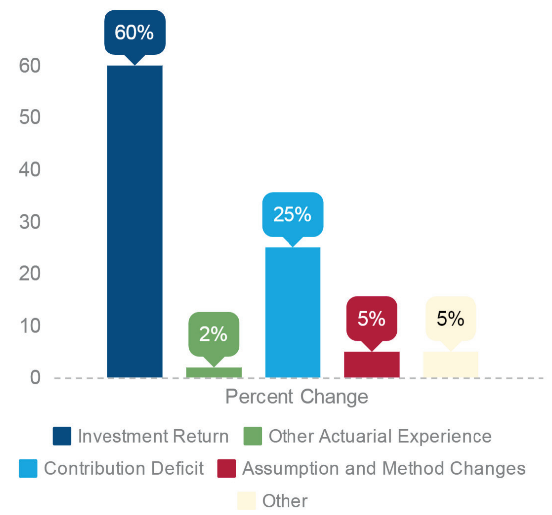
It has been widely reported that the failure of the Governor and General Assembly to adequately fund the full employer's contribution to the pension systems contributed to the underfunding crisis. However, it is important to note that other factors, such as investment losses since the 2008 recession and failure to meet ACTUARIAL ASSUMPTIONS, also played a key roll in the pension shortfall.

The charts below quantify the key contributors to pension underfunding for the public employee and teacher retirement systems. In both cases, investment returns falling short were major factors:

Sources of Underfunding for Kentucky Employee Retirement Systems



Percent Change In Unfunded Liabilities by Cause, Teachers' Retirement System, 2009—2013



Social Security's role

An important part of the retirement equation for public employees is whether they are eligible for Social Security benefits. Unlike other government employees, Kentucky teachers do not participate in Social Security and are not eligible for benefits. Because of this, teacher retirement benefits are higher than those provided to state and local government employees.

A task force studying teachers' retirement recently discussed moving new teachers to a DEFINED CONTRIBUTION PLAN (401K plan) and placing them in Social Security. A number of issues arose from this proposal, including:

- The retirement benefits provided to teachers from a 401K plan would be about half of the amount provided by the current retirement system.
- The unfunded liability of the teachers' retirement system (more than $13.9 billion) would still have to be addressed for the more than 127,000 active and retired teachers participating in the current system.
- The state would have to pay the EMPLOYER CONTRIBUTION for Social Security (6.2% of payroll) for new teachers.

PENSION TERMS DEFINED

DEFINED CONTRIBUTION PLAN

A retirement plan to which the employer, and often the employee, contribute a defined amount (for example, 8 percent of salary) to an account in the employee's name while the employee is working, but which does not guarantee a set benefit. The amount available for retirement is based on the amount of money that has been saved, along with investment income credited to the employee's account. When a retiree receives all of these funds, the benefit is exhausted.

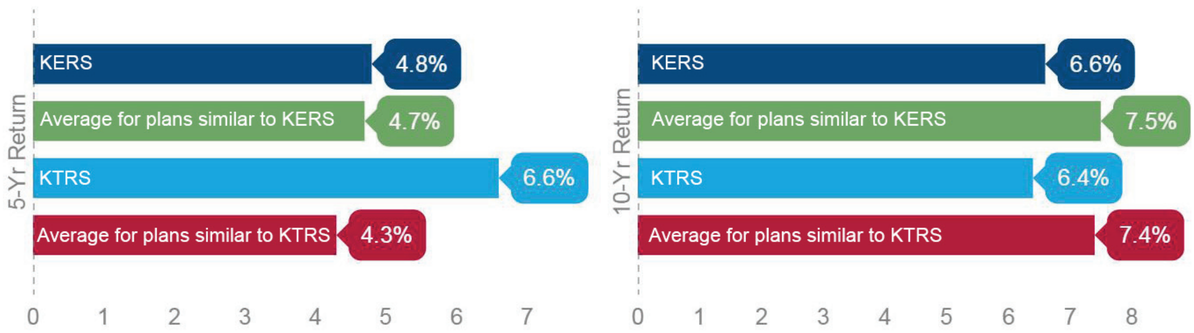
EMPLOYER/EMPLOYEE CONTRIBUTION

The amount paid by the employer and employee each month into the employee pension plan. The contribution is usually based on a percentage of the employee's salary/wages.

Comparison to other states

The Public Plans Database maintained by The Center for Retirement Research at Boston College and the National Association of State Retirement Administrators annually tracks the performance of public pension systems on a number of key metrics. Since investment returns contributed to underfunding, the table below shows how the investment performance of the teachers' (KTRS) and state employees' (KERS) systems compares with national averages for similar plans for the years 2001 to 2013.

Annualized Investment Returns for KERS and KTRS, 2001-2013



Source: Public Plans Data, Center for Retirement Research, Boston College

High investment costs a factor

Other than the performance of financial markets, an important factor that affects investment returns is how much money a retirement system spends to make investments. A report by CEM Benchmarking (a global benchmarking firm specializing in cost and performance of investments and administration) found the Kentucky Retirement System's annual investment expenses in 2014 were actually more than 100 percent higher than what the system reported: $126.6 million instead of the $62.4 million the system reported. CEM Benchmarking found that much of the increase resulted from newly disclosed fees paid to private equity firms. The report also found that the investment fees paid by the retirement system were 9 percent higher than those paid by 18 similar public retirement plans (the plans were not identified in the report). Kentucky's total investment cost was 81.6 basis points compared to an average of 74.8 basis points for peer funds (one basis points equals 0.01%).

Driving up public project costs

BOND RATING AGENCIES have lowered Kentucky's credit rating several times in recent years, citing the state's huge unfunded pension liabilities as a key factor. The most recent downgrade was by Standard and Poor's Rating Service in September 2015. Failure to pay down Kentucky's unfunded pension liabilities will further affect the state's credit rating, increasing the state's cost to borrow money and limiting public construction projects that create private sector jobs and spur economic growth. A real-world example: A downgrade of Illinois' credit rating due to pension liabilities even higher than Kentucky's increased the cost of a $1.3 billion bond issue for construction projects in that state by $95 million over the term of the bonds. This increased cost was enough to fund the construction of at least four high schools or 12 elementary schools.

PENSION TERMS DEFINED

BOND RATING AGENCIES

Companies that assess whether bonds or other debt securities – and the private companies and governments that issue them – are credit worthy. The three primary bond rating agencies in the United States are Standard and Poor's, Moody's and Fitch. Bonds are rated using a letter-based system (AAA, AA, A-, B, etc.) that indicates the risk of default and the financial stability of the issuer.

PENSION TERMS DEFINED

CASH BALANCE OR HYBRID PLAN

A retirement plan that combines the features of a plan that sets a certain benefit level and one that sets a certain contribution level. Employees receive an individual retirement account (IRA) that both the employer and employee pay into. The employer guarantees a minimum return. When actual returns exceed the guaranteed rate, the extra money is shared between the employer and employee. Retirement benefits are based on the amount of money in an employee's IRA when he or she retires.

PUBLIC PENSION OVERSIGHT BOARD

Also known as PPOB, this state board assists the General Assembly with its review, analysis and oversight of the administration, benefits, investments, funding, laws, administrative regulations and legislation relating to the public retirement systems in Kentucky. The board consists of 13 members, including six members of the General Assembly, the State Budget Director, the Auditor of Public Accounts, the Attorney General and four financial experts (two appointed by the Governor and two by the General Assembly).

Recent system changes

Kentucky has made changes to its public pension systems in recent years. The following summarizes these changes by year of enactment by the Kentucky General Assembly:

2003

Limits on health insurance benefits for retirees in KRS

2008

For new state employees: increase in employee contribution; impose Rule of 87 (age at retirement plus years of service must equal at least 87); impose minimum retirement age of 57; use high five- instead of high three-year salary to calculate benefits; accrued overtime cannot count toward years of service; 15 years of service required to be eligible for health insurance. For new teachers: increase employee contribution; early retirement changed from age 55 with five years of service to age 55 with 10 years of service; 15 years of service required to be eligible for health insurance

2010

"Shared Responsibility" plan implemented for providing funding for health insurance for retired teachers by requiring active teachers to contribute an additional 3.75% of salary by 2015 to pay for health insurance

2013

Major reform of Kentucky Retirement Systems (which includes state and local government employees) included: payment of full actuarially required contribution by legislature; suspension of cost of living adjustments for current retirees unless prefunded; limits placed on the "spiking" of pensions (where raises are given to employees immediately before retiring to boost retirement benefits); a HYBRID DEFINED CONTRIBUTION PLAN for new employees hired after January 1, 2014, with a 401K-style account with a guaranteed return of 4% per year; new employees are not covered by inviolable contract provisions (the Kentucky Teachers' Retirement System was not affected by these changes)

Recommendations

As noted previously, some progress has been made in reforming Kentucky's pension systems. But given their current financial condition and critical level of unfunded liabilities, the Kentucky Chamber believes a number of additional steps must be taken to improve the systems' operation, transparency and funding levels. These include, but are not limited to:

- Comprehensive performance audits of Kentucky retirement systems
- Increased levels of transparency in which: each system clearly reports its investment returns net of any fees paid to make the investments (for example, 2014 investment returns for KRS should account for the $126.6 million paid in investment fees); the Governor and General Assembly clearly report the percentage of the actuarially required contribution being funded in the biennial budget; and the development of a database that reports annual pension amounts for individual retirees, including elected officials
- An annual report from the PUBLIC PENSION OVERSIGHT BOARD, prepared with the assistance of independent experts, that analyzes the operation of each pension system compared to other states based on such key metrics as: funding levels, investment returns, percentage of the required contribution paid, accuracy of actuarial assumptions and administrative costs
- An increase in funding levels of the Kentucky Teachers' Retirement System by implementing a plan for the General Assembly to phase in paying the full actuarially required contribution, coupled with a decrease in retirement benefits for newly hired teachers ("shared responsibility" model)
- A contingency plan that infuses additional cash into the Kentucky Employees Retirement System if investment levels are depleted, coupled with a reduction in retirement benefits for retirees hired after January 1, 2014 (as the inviolable contract does not apply to them)
- Reviewing the ramifications of moving employees to a 401K plan
- Prohibiting any entity or individual seeking to provide investment services to any Kentucky retirement system from making any political contributions, gifts or offers of employment to any official of Kentucky's retirement systems, any member of the General Assembly, any member of the Governor's Executive Cabinet, any constitutional officer or their spouses and/or their children

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Thanks to Kentucky Chamber members, the Commonwealth's business community has achieved many legislative successes over the years. Because the Chamber represents a wide range of businesses, legislators listen when we speak on your behalf.

The Kentucky Chamber uses membership dollars to encourage:

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- A sustainable state government
- 21st Century infrastructure
- Aggressive job creation

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