William B. Fornia, FSA | President

Re: "Keeping the Promise" Pension Reform in Kentucky

Pension Trustee Advisors (PTA) has conducted a review of the proposed changes to the pension and retiree healthcare benefits for current and future Kentucky public employees known as "Keeping the Promise" for the Kentucky Public Pension Coalition.

While the recommendations include adequate funding of the retirement systems, the changes to the pension benefits proposed are substantial and in many cases result in benefit levels lower than currently provided and lower than proposed in the August 28 PFM report.

This brief report will summarize our findings and provide an overview of areas which may need to be analyzed further.

Summary of Findings

- **Inadequate Benefit Levels** will result for future workers
- **Reduced Benefit Levels** – in many instances for current workers
- **Suspended COLAs** – equate to a substantial benefit cut
- **Health care contributions** – equate to a significant pay cut
- **Limited preretirement death and disability benefits** – are a result of DC plans
- **Funding reform** while helpful, results substantially on the backs of workers and retirees

Key Finding – Inadequate Benefits for Future Workers

We have not precisely calculated the benefit levels for each class of Kentucky public workers, but it generally appears that benefit levels will be lower than currently offered and in many cases, lower than proposed in the latest PFM report. We expect that a fiscal analysis will perform the same robust benefit calculation illustrations that were provided in August. While we have some issues with the methodology and assumptions used, that report provided an excellent comparison of proposed benefits with benchmarks of adequate pension income. In the meantime, we will illustrate a few of our calculations below. We look forward to reviewing calculations to be released.

Future Teachers

Currently, teachers are covered by a defined benefit (DB) plan. Non-university teachers contribute 9.105% of pay for this plan plus 3.75% of pay for retiree health care. The new proposal is that they would be covered by a defined contribution (DC) plan comprised of mandatory 9% of pay contributions plus 3% voluntary contributions plus 6% employer contributions. In addition, these new teachers would be required to pay 6.75% of pay for retiree healthcare.

The August proposal was for Social Security Coverage plus a DC plan with up to 14% total contributions. For the hypothetical future teacher, PFM calculated a total replacement income ranging from 72% to 83%. Based on these figures, we would expect that the PFM-calculated replacement ratios will range from 57% to 65%. These are far below a target replacement income of 78%. Even using PFM's optimistic assumptions, future Kentucky teachers will not be able to retire even at age 65 or 67 despite saving 18.75% of their pay for thirty years or more. The following table illustrates benefit levels for this group:

Benefit Illustrations for Future Teachers

Retirement Age	65	67	67
Service at Retirement	30	30	32
PFM Benefit Calculations on proposed plan in August report			
Replacement Income from Social Security	28%	32%	33%
Replacement Income from 14% DC	44%	47%	50%
Replacement Income Total	**72%**	**79%**	**83%**
PTA Benefit Calculations on proposed plan in August report			
Replacement Income from 14% DC	27%	29%	31%
Replacement Income Total	**55%**	**61%**	**64%**
Anticipated PFM Benefit Calculations on proposed plan from November legislation			
Replacement Income Total from 18% DC (no Social Security)	**57%**	**61%**	**65%**
PTA Benefit Calculations on proposed plan from November legislation			
Replacement Income Total from 18% DC (no Social Security)	**36%**	**38%**	**41%**
PTA Benefit Calculations on current DB plan			
Replacement Income from current DB plan	**71%**	**71%**	**76%**

Future KRS Non-Hazardous Members

Future KERS and CERS Non-Hazardous employees will have mandatory 3% DC contributions and 4% retiree healthcare contributions plus voluntary contributions which need to be at 6% in order to get a full match. The employer DC contributions are 2% plus a 50% match on voluntary contributions up to 6%. This means that to maximize benefits, employees must contribute 9% (plus 4% to healthcare and 6.2% to Social Security). With the employer contributing 5% (2% plus 50% x 6%), total DC contributions are 14%. This is similar to the plan proposed in the August PFM report. PFM projected that this would result in replacement income of 105% for the 67-year-old retiree with 37 years of service. PTA calculated 75% of pay replacement based on more reasonable assumptions.

The primary impact of this proposed change is that employees must make total contributions of 19.2% of pay in order to attain maximum pension benefits. This results in take-home pay 7% less than under the current arrangement of 12.2% (5% CB plus 1% health care plus 6.2% Social Security)

Future KERS Hazardous Members

Future KERS Hazardous employees will have the same modest CB plan that they have today. They will have the option to switch to a DC plan, but this is not expected to improve their retirement potential. PFM in their August report calculated that these workers would attain replacement income of 72% if retiring at age 60 with 30 years and 80% if retiring at age 62 with 32 years. PTA calculated these figures on less rosy assumptions as 59% and 62%, respectively.

Future CERS Hazardous Members

Future CERS Hazardous employees will have the same inadequate CB plan that they have today. They will have the option to switch to a DC plan, but this is not expected to improve their retirement potential. PFM in their August report calculated that these workers would attain replacement income of only 50% if retiring at age 60 with 30 years and 57% if retiring at age 62 with 32 years. PTA calculated these figures on less optimistic assumptions as 32% and 39%, respectively. [Note that the October 10 PTA report reversed the 32% and 39% figures on page 6]. The PFM report suggested that they would need to invest much of the take-home-pay that they save by not participating in Social Security (up to 6.2%) in personal savings accounts to approach the target replacement income. We find that this can only be met if the optimistic assumptions are achieved, which include:

- investment returns as strong as those attained by professionally managed long-term DB plans,
- ignoring inflation, and
- not living as long as the average retiree.

Reduced Benefits for Current Workers

Current workers have various transition benefits which may result in reductions in benefits. A partial analysis follows:

Current Teachers

The most significant impact to teachers is the COLA suspension which will be discussed below. In addition, several specific reductions will apply.

Current teachers will not accrue any additional benefits under the DB plan once they attain retirement eligibility, which is 27 years of service or age 60 with five years of service. Once they meet this eligibility requirement, they will begin to accrue benefits through a DC plan.

Certain other benefit changes also apply to current teachers:

- Three Year Final Average Salary provision will not apply after 2023
- Sick Leave retirement benefits will phase out
- Compensation limits will be introduced to address “pension spiking”
- 3% benefit factor for service after thirty years will be modified
- Reemployment provisions will be changed

We have not analyzed the financial impact of these changes on either the employees or the employer. It does seem counterproductive, however, to create any incentive for individuals to retire early.

Current KRS Non-Hazardous Members

Tier III members will transition from the 9% CB plan to a 14% DC plan, similar to such future members. The analysis above also pertains to these members.

As with the teachers, Tier I and Tier II non-hazardous members will cease accruals once they attain unreduced retirement eligibility (which vary between Tier I and Tier II). They also have other changes similar to those for teachers:

- Five Year Final Average Salary will need to be complete fiscal years beginning in 2018
- Sick Leave retirement benefits will phase out
- Compensation limits will be introduced to address "pension spiking"
- Reemployment provisions will be changed

Current KRS Hazardous Members

The hazardous members will have no major change to their retirement benefit structure. The inadequate CB benefits, particularly for CERS, will continue. Modest changes will also occur:

- Sick Leave retirement benefits will phase out
- Compensation limits will be introduced to address "pension spiking"
- Reemployment provisions will be changed

COLA Suspension for Retired Teachers

KTRS currently provides a 1.5% cost of living adjustment (COLA) each year. The proposed legislation eliminates this for five years for all current members. Over a full lifetime, this equates to an approximately 5% reduction in benefit value. Teachers at or near retirement will not have time to make up for this loss.

Health Care Contributions Represent a Significant Pay Cut

Under the new proposal, workers across the spectrum will be required to increase their preretirement contributions toward retiree healthcare.

Group	Current Contribution Requirement	Proposed Contribution Requirement	Equivalent Pay Cut
KTRS	3.75%	6.75%	3.00%
KRS Tier I	0.00%	3.00%	3.00%
Other KRS	1.00%	4.00%	3.00%

For all workers, this equates to a 3% cut in pay. While we have not reviewed the retiree healthcare actuarial results rigorously, it appears that the normal cost of the program is only about 2% of pay (according to KTRS CAFR). This would indicate that these workers are paying more than the full cost of their retiree healthcare benefits. We recommend further analysis.

Limited Pre-Retirement Death and Disability Coverage

While DB plans often provide benefits for members who die or become disabled prior to retirement, CB and DC plans are limited in their ability to provide such benefits. While the current cash balance program provides a modest level of disability benefits, which when combined with Social Security might result in an adequate income replacement, the new defined contribution programs have no disability coverage, which will result in inadequate retirement income for some of the most vulnerable former employees. The proposed solution of optional employee-paid disability represents a significant takeaway. Disability for KTRS, for example, represents about 5% of the total benefit value.

Financial Considerations

As an actuary, I am pleased to see that the government will begin to appropriately fund the retirement systems. But because of the substantial reductions in benefits, this appears to be primarily passed on to the workers. For example, the employer KTRS normal cost for current Tier III is only 5.83% of pay. After reducing COLA and other changes, it would decrease by at least 1%. The proposed plan requires 6% employer DC contributions in order for the workers to attain full benefits. If the employer expects to save money, it would only occur to the extent that past teacher benefits are cut and future teachers can't afford the dramatically increased contributions which generate the employer match.

Conclusions

The proposed legislation will result in less than adequate retirement benefits for nearly all future Kentucky workers and result in significant takeaways for most current workers and retirees. We believe that the proposed reform of the currently inadequately funded pension program does not address this significant funding problem in a balanced and cost efficient manner.

As previously, we are available to discuss our findings further with your entities or other decision-makers as appropriate. Actuarial calculations were performed under the direction of or by William B. Fornia, FSA, who meets the qualification requirements of the American Academy of Actuaries to render this actuarial opinion.

Sincerely,

William Fornia, FSA

November, 2017