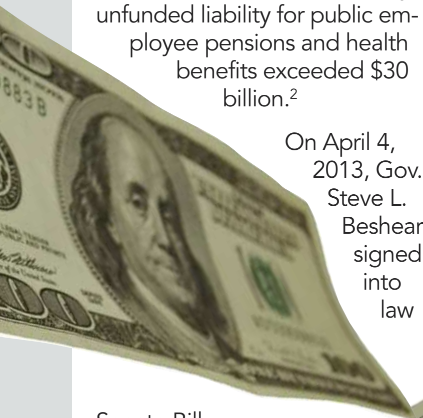
KENTUCKY PENSION REFORM UNDER SENATE BILL 2

By: R. Douglas Martin, J. D. Chaney, and Jonathan M. Hollinger

Kentucky has one of the worst-funded government retirement systems in the nation.[1] Despite several attempts to fix the problem, as of June 2011, Kentucky's unfunded liability for public employee pensions and health benefits exceeded $30 billion.[2]

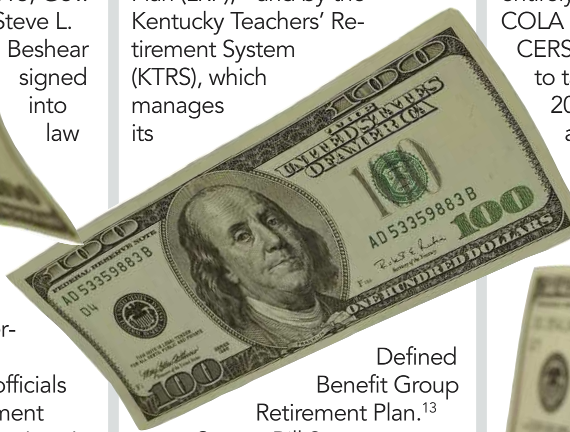


On April 4, 2013, Gov. Steve L. Beshear signed into law Senate Bill 2, which adopted hybrid "cash balance retirement plans" for certain new state and local public employees and officials participating in government pension plans on or after Jan. 1, 2014.[3] On the same day, Gov. Beshear signed House Bill 440, which allocated approximately $100 million in new tax revenues to the payment of Kentucky's annual pension obligations.[4] These legislative efforts, along with recently revised accounting standards for government pensions,[5] will significantly impact public pension obligations and benefits in the years ahead.

ADMINISTRATION OF PUBLIC PENSIONS

Retirement benefits for Kentucky's public employees and officials are managed by a number of state agencies. The Kentucky Retirement Systems administers three pension systems — the State Police Retirement System (SPRS),[6] the Kentucky Employees Retirement System (KERS),[7] and the County Employees Retirement System (CERS)[8] - which together provide retirement benefits for a significant number of state and local governmental employees in Kentucky.[9] As of June 30, 2013, about 1,126 separate employers participated in CERS, and 348 separate employers participated in KERS.[10]

Retirement benefits for other public employees and officials are administered by the Kentucky Judicial Form Retirement System, which oversees the Judicial Retirement Plan (JRP)[11] and the Legislators' Retirement Plan (LRP),[12] and by the Kentucky Teachers' Retirement System (KTRS), which manages its



Defined Benefit Group Retirement Plan.[13] Senate Bill 2 attempts to stabilize the finances of pension plans managed by the Kentucky Retirement Systems and the Kentucky Judicial Form Retirement System, but does not address any of the substantial financial deficiencies in KTRS.[14]

PREVIOUS LEGISLATIVE EFFORTS

Senate Bill 2 follows several previous legislative efforts to address rising public employee retirement costs. In 2004, the Kentucky General Assembly made changes to health insurance benefits for public employees, adjusted disability benefits, and for new hires increased the insurance contribution rates and extended the required length of service.[15] In 2008, the legislature added a one percent required contribution to the insurance trust fund for new hires, changed the retirement compensation calculations for new non-hazardous duty employees to the average of the employee's annual salaries during the final five years before retirement (as opposed to the average of the employee's three highest annual salaries), imposed a minimum retirement age of 57 years and reduced the benefits multiplier for new hires, and reduced automatic annual "cost-of-living adjustments" (COLAs) for all participants of SPRS, KERS, CERS, JRP, and LRP.[16]

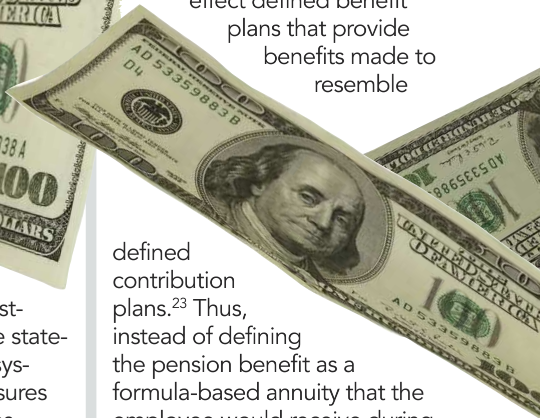
Finally, in 2012, the legislature entirely suspended automatic COLA increases for SPRS, KERS, CERS, JRP, and LRP scheduled to take effect on July 1, 2012, and July 1, 2013.[17] In addition, the Kentucky Public Pensions Task Force was created to "study and develop

consensus recommendations concerning the benefits, investments, and funding of the state-administered retirement systems, and any other measures that the task force believes would lead to the improved financial stability of the state-administered retirement systems."[18] The consensus recommendations adopted by the Kentucky Public Pensions Task Force formed the basis of many of the pension reforms enacted in Senate Bill 2.[19]

HYBRID CASH BALANCE PLANS

Prior to Senate Bill 2, each of Kentucky's public employee pension plans operated as "defined benefit plans," which provide lifetime retirement benefits for participants based on statutory formulas irrespective of plan contributions or investment performance.[20] In contrast, most private businesses have shifted away from defined-benefit plans in favor of "defined contribution plans,"[21] where retirement benefits are tied to a participant's accumulated account balance at retirement. Benefits from a defined-contribution plan ultimately depend on the actual contributions made to the plan by the employer and employee, but also are affected by investment performance, the employee's life span, and other important factors.[22]

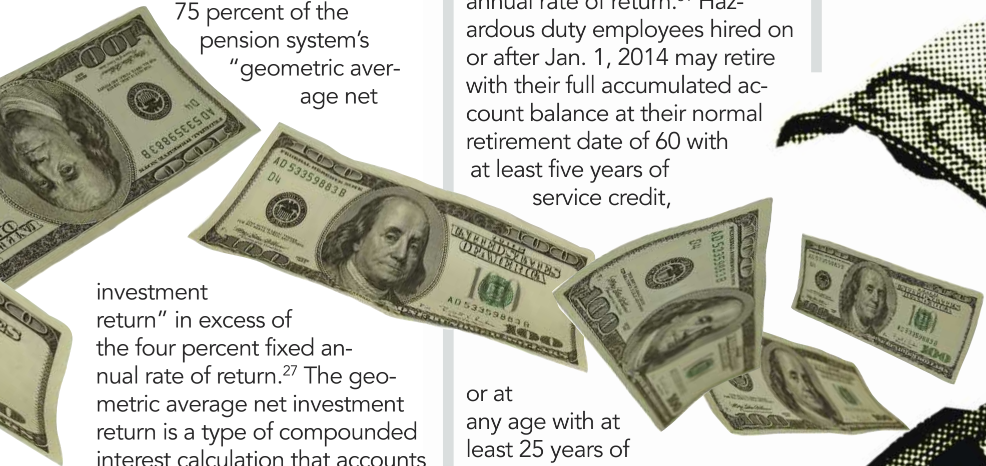
Senate Bill 2 introduces new pension benefit tiers for Kentucky public employees and officials with participation dates starting on or after Jan. 1, 2014. These new "hybrid cash balance plans" are in effect defined benefit plans that provide benefits made to resemble



defined contribution plans.[23] Thus, instead of defining the pension benefit as a formula-based annuity that the employee would receive during retirement, as is the case with traditional defined benefit plans, the hybrid cash balance plan defines the benefit as a hypothetical lump sum that the employee would receive at retirement, which can fund annuity payments to the employee during retirement.[24]

Kentucky's new hybrid cash balance plans provide participants with a hypothetical lump sum benefit known as the "accumulated account balance," which is made up of (i) contributions from the employee during their working years, (ii) an employer "pay credit" equal to a percentage of the "creditable compensation" paid during the employee's working years, and (iii) an "interest credit" that is added to the accumulated account balance each year.[25] Once the employee has retired and converted his or her accumulated account balance to a lump sum payment or to a monthly retirement annuity, the retirement benefit becomes fixed and no additional employer pay credits or interest credits are added to the accumulated account balance.[26]

The "interest credit" is a hypothetical rate of return that is added to the employee's accumulated account balance each year until retirement. The interest credit is calculated by multiplying (i) the amount of the employee's accumulated account balance effective June 30 of the preceding fiscal year, by (ii) a percentage increase, which is a four percent fixed annual rate of return, plus an additional 75 percent of the pension system's "geometric average net investment return" in excess of the four percent fixed annual rate of return.[27] The geometric average net investment return is a type of compounded interest calculation that accounts for both positive and negative returns, and generally is the average annual investment return for the pension fund over the previous five fiscal years, less fees and expenses.[28] Unlike defined contribution plans, such as individual retirement accounts, the assets of hybrid cash balance plans are invested for the pension system as a whole and are not directed by individual plan participants.



PENSION CONTRIBUTIONS

Under Senate Bill 2, employee contributions and employer pay credits will continue to be made at a higher level when a participant's job is classified as "hazardous duty." For hazardous duty participants of SPRS, KERS, and CERS hired on or after Jan. 1, 2014, the member's accumulated account balance will be made up of (i) an employee contribution of eight percent of "creditable compensation" plus insurance for each employee pay period,[29] plus (ii) an "employer pay credit" of 7.5 percent of creditable compensation for each employee pay period,[30] plus (iii) an "interest credit" equal to a fixed annual rate of return of four percent, with the employee's account balance also receiving 75 percent of the pension system's "geometric average net investment return" in excess of the four percent fixed annual rate of return.[31] Hazardous duty employees hired on or after Jan. 1, 2014 may retire with their full accumulated account balance at their normal retirement date of 60 with at least five years of service credit, or at any age with at least 25 years of service credit.[32]

For the members of JRP and LRP and the non-hazardous duty members of KERS and CERS hired on or after Jan. 1, 2014, employee contributions and employer pay credits will continue to be made at a lower level than for their hazardous duty counterparts. The accumulated account balances for these new participants will be made up of (i) an employee contribution of five percent of "creditable compensation" plus insurance for each employee pay period, plus (ii) an "employer pay credit" of four percent of creditable compensation for each employee pay period, plus (iii) an "interest credit" equal to a fixed annual rate of return of four percent, with the member's account balance also receiving 75 percent of the pension system's "geometric average net investment return" in excess of the four percent fixed annual rate of return.[33] These non-hazardous duty members may retire with their full accumulated account balance at their normal retirement date of 65 with at least five years of service credit, or at any time so long as the employee is at least 57 years of age and the employee's age and total years of service add up to at least 87 years.[34]

PAYMENT OPTIONS UPON RETIREMENT

Senate Bill 2 provides participants in the new hybrid cash balance plans with a number of payout options once they are eligible to retire. Members may elect to receive a traditional lifetime monthly annuity payment based on their accumulated account balance and the mortality and investment assumptions of the plan as of the date of their retirement.[35] Alternatively, participants may elect to receive upon retirement the actuarial equivalent of their accumulated account balance under one of several optional payment methods, including plans for surviving beneficiaries, social security adjustment options, and partial lump sum options.[36] Members may also elect to take a refund of their account balance or contributions.[37]

Participants in the new hybrid cash balance plans with less than five years of service who elect to take a refund of their accumulated account balance will forfeit accumulated employer pay credits, and will only receive a refund of their accumulated contributions plus interest.[38] Participants with more than five years of service may elect to receive a full refund of their accumulated account balance.[39]

COST OF LIVING ADJUSTMENTS

Automatic COLAs have consistently been viewed as one of the main contributing causes to Kentucky's pension problems. As previously discussed, in 2008 the Kentucky General Assembly instituted a fixed COLA of 1.5 percent per year for participants, and then suspended COLAs entirely in the 2012 budget for fiscal years beginning on July 1, 2012 and July 1, 2013. Senate Bill 2 ratifies the previous suspension of COLAs in the 2012 budget,[40] and prohibits any future COLAs to retirees or beneficiaries unless the benefit is prefunded by the General Assembly or funds are otherwise available. Recipients of monthly pension benefits may receive a 1.5 percent COLA in a given fiscal year if the funding level of their pension plan is greater than 100 percent and if the legislature authorizes the use of any excess pension plan funding for the COLA.[41] Alternatively, recipients may receive a 1.5 percent COLA in a given fiscal year if the legislature appropriates sufficient funds to fully prefund the COLA in the year it is granted.[42] Unlike the hybrid cash balance plans adopted in Senate Bill 2, which only apply to participants beginning on or after Jan. 1, 2014, the prohibitions on future COLAs in Senate Bill 2 apply to both current and future participants of SPRS, KERS, CERS, JRP, and LRP.

PENSION SYSTEM OVERSIGHT

Senate Bill 2 adopts a number of measures designed to provide increased accountability and oversight of the Kentucky Retirement Systems. First, KRS 61.645 was amended to add four new members to the Board of Trustees of the Kentucky Retirement Systems — one additional trustee to be selected by CERS participants, and three trustees to 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.[43]

Senate Bill 2 also established the Public Pension Oversight Board in KRS Chapter 7A to "review, analyze, and provide oversight to the General Assembly on the benefits, administration, investments, funding, laws and administrative regulations, and legislation pertaining to the Kentucky Retirement Systems."[44] The Public Pension Oversight Board is made up of 13 members — two members of the Kentucky General Assembly appointed by the speaker of the House of Representatives; two members of the Kentucky General Assembly appointed by the president of the Senate; one member of the Kentucky General Assembly appointed by the minority floor leader of the Senate; one member of the Kentucky General Assembly appointed by the minority floor leader of the House of Representatives; one chartered financial analyst appointed by the speaker of the House of Representatives; one chartered financial analyst appointed by the president of the Senate; the state budget director; the auditor of public accounts; the attorney general; and two individuals appointed by the governor, one who is to be a chartered financial analyst and one who is to have at least 10 years of "professional retirement experience."[45]

Senate Bill 2 empowers the Public Pension Oversight Board with broad authority to supervise the Kentucky Retirement Systems, including the ability to conduct hearings and to review benefit plans, investments, and proposed regulations.[46] In addition, the Public Pension Oversight Board is required to publish an annual evaluation of the Kentucky Retirement Systems, which must be submitted to the Legislative Research Commission no later than December 1 of each year, and which must include "any legislative recommendations made by the board, a summary of the financial and actuarial condition of the Kentucky Retirement Systems, and an analysis of the adequacy of the current levels of funding."[47]

ACTUARIALLY REQUIRED CONTRIBUTIONS

Effective with each plan's 2013 actuarial valuation, Senate Bill 2 resets the amortization periods for full funding of KERS, CERS, and SPRS to a new 30-year period for purposes of calculating the "actuarially accrued liability contribution" that participating employers are required to contribute.[48] Additionally, Senate Bill 2 mandates that the "General Assembly shall pay the full actuarially required contribution rate" for CERS, KERS, and SPRS for fiscal years occurring on or after July 1, 2014,[49] although fulfillment of this mandate will depend upon future appropriations by the General Assembly.

ANTI-SPIKING PROVISIONS

Senate Bill 2 includes "anti-spiking" provisions for members of the KERS, SPRS, and CERS[50] to ensure that employers adequately fund any new pension liabilities resulting from increases in an employee's compensation during the five years leading up to retirement. For employees retiring on or after Jan. 1, 2014, the "last participating employer" must pay the additional actuarial costs resulting from annual increases in an employee's creditable compensation greater than 10 percent over the employee's last five fiscal years of his or her employment not directly resulting from a "bona fide promotion or career advancement."[51] A bona fide promotion or career advancement must be (i) professional advancement in substantially the same line of work held by the employee during the four years immediately prior to the final five fiscal years preceding retirement, or (ii) a change in employment position based on the training, skills, education, or expertise of the employee that imposes a significant change in job duties and responsibilities to clearly justify the increased compensation to the member.[52]

REPEAL OF INVIOLABLE CONTRACT

To preserve the ability to adopt future changes to Kentucky's new hybrid cash balance plans, the General Assembly reserved the right "to amend, suspend, or reduce the benefits and rights provided" to pension plan participants with start dates on or after Jan. 1, 2014, except with respect to benefits that members have already accrued at the time of any amendment, suspension, or reduction.[53] While this provision does not apply to individuals hired prior to 2014, new employees and public officials participating in Kentucky's hybrid cash balance plans on or after Jan. 1, 2014, may see their contribution rates raised, benefits reduced, or retirement requirements changed in future years.[54]

CONCLUSION

Senate Bill 2 reforms Kentucky's public employee pensions in a number of important ways. New "cash-balance retirement plans" are established for public employees and officials that begin their participation in SPRS, KERS, CERS, JRP, or LRP on or after Jan. 1, 2014. With these new hybrid plans, a participant's retirement benefit will be based on a hypothetical "accumulated account balance" consisting of employee contributions, employer pay credits, and a guaranteed minimum investment return of four percent. This accumulated account balance can then be converted into a lump sum payment or a lifetime monthly annuity upon retirement. In addition, the legislation addresses COLAs for all participants of SPRS, KERS, CERS, JRP, and LRP, which will only be allowed if the Kentucky General Assembly allocates funds to prepay the cost of any increase, or if sufficient excess funding in the pension plan exists to cover additional costs at the time the COLA is granted. Finally, Senate Bill 2 obligates the Kentucky General Assembly to begin making its full "actuarially required contributions" for public employee pensions beginning in Fiscal Year 2015, but these payments will require allocations by the legislature in future budget bills.[55] Deficiencies in the Kentucky Teachers' Retirement System were not addressed.

With the enactment of Senate Bill 2, the legislature has taken a number of very important steps towards resolving Kentucky's pension crisis. Undoubtedly, the legislature and the newly formed Public Pension Oversight Board will propose additional reforms and improvements in the years ahead, as Kentucky continues to address the substantial budget challenges raised by its public employee pensions. B&B

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1 *See* "Kentucky's Successful Public Pension Reform," The Pew Charitable Trusts and the Laura and John Arnold Foundation, at page 2 (September 2013).
2 *See* 2012 Ky. Acts, Regular Session, Ch. 155 (HCR 162).
3 *See* 2013 Ky. Acts, Regular Session, Ch. 120 (SB 2).
4 See 2013 Ky. Acts, Regular Session, Ch. 119 (HB 440).
5 *See* L. Watters, J. Hollinger, and R. Martin, "New Accounting Standards for Government Pensions," Kentucky Bench & Bar (March 2014).
6 *See* KRS 16.505 to 16.652.
7 *See* KRS 61.510 to 61.705.
8 *See* KRS 78.510 to 78.852.
9 The Policeman's and Firefighter's Retirement Fund is a separate pension system maintained by the Lexington-Fayette Urban County Government for employees of its police and fire departments. *See* KRS 67A.360 to 67A.690 (2013). In addition, the Kentucky Retirement Systems also administers the "Kentucky Retirement Systems Insurance Trust Fund" pursuant to KRS 61.701.
10 *See* Adam H. Edelen, Kentucky Auditor of Public Accounts, "Report of the Audit of the Kentucky Retirement Systems for the Fiscal Year Ended June 30, 2013," pages 26–27.
11 *See* KRS 21.345 to 21.580.
12 *See* KRS 6.500 to 6.535.
13 *See* KRS 161.220 to 161.716, & KRS 161.990.
14 In 2012, the unfunded liability for KTRS alone was approximately $12.3 billion. *See* "Kentucky's Successful Public Pension Reform," The Pew Charitable Trusts and the Laura and John Arnold Foundation, at page 2 (September 2013).
15 *See generally,* 2004 Ky. Acts, Regular Session, Ch. 33 (HB 290); 2004 Ky. Acts, Regular Session, Ch. 36 (HB 519).
16 *See generally,* 2008 Ky. Acts, Extraordinary Session, Ch. 1 (HB 1).
17 *See generally,* 2012 Ky. Acts, Regular Session, Ch. 19, Part I, Section 1(4) (HB 268); 2012 Ky. Acts, Regular Session, Ch. 68, Part I(1), Section 2(2) (HB 269); 2012 Ky. Acts, Regular Session, Ch. 144, Part IV, Section 10 (HB 265).
18 *See* 2012 Ky. Acts, Regular Session, Ch. 155 (HCR 162).
19 *See* "Kentucky's Successful Public Pension Reform," The Pew Charitable Trusts and the Laura and John Arnold Foundation, at page 2 (September 2013).
20 *See generally,* "Overview of the Kentucky Retirement Systems," Kentucky Association of Counties (2011).
21 In March of 2009, only 20 percent of private industry workers participated in defined-benefit plans versus 79 percent of state and local government workers. *See* "Frozen Defined-Benefit Plans," *Program Perspectives*, Vol. 2, Issue 3, U.S. Bureau of Labor Statistics (April 2010).
22 *See generally,* "Overview of the Kentucky Retirement Systems," Kentucky Association of Counties (2011).
23 "Hybrid (Cash Balance) Pension Plans," Testimony of David Certner, Director of Federal Affairs, American Association of Retired Persons (AARP), before the Subcommittee On Retirement Security And Aging, of the Committee On Health, Education, Labor, And Pensions, United States Senate (June 7, 2005).
24 *Id.*
25 *See* KRS 16.583(2); KRS 21.402(2); and KRS 61.597(2).
26 *See* KRS 16.583(4)(e); KRS 21.402(4)(e); KRS 61.597(4)(e).
27 *See* KRS 16.583(4)(b); KRS 21.402(4)(b); KRS 61.597(4)(b).
28 *See* KRS 16.583(4)(d); KRS 21.402(4)(d); KRS 61.597(4)(d).
29 *See* KRS 16.545(1); KRS 61.592(3)(a).
30 See KRS 16.583(2)(b).
31 *See* KRS 16.583(2), (3) & (4).
32 *See* KRS 16.505(15); KRS 16.583(6).
33 *See* KRS 6.505(1)(d); KRS 21.402(2), (3) & (4); KRS 61.597(2), (3) & (4).
34 *See* KRS 21.402(6); KRS 61.597(6).
35 *See* KRS 16.583(7)(a); KRS 21.402(7)(a); KRS 61.597(7)(a). Senate Bill 2 leaves these mortality and investment assumptions to the discretion of the Kentucky Retirement Systems and the Kentucky Judicial Form Retirement System. Thus, some questions exist as to the budget impact of assumed rates of return to be applied by the Kentucky Retirement Systems or the Kentucky Judicial Form Retirement System when calculating lifetime monthly annuity benefits for retirees.
36 *See* KRS 16.583(7)(b); KRS 21.402(7)(b); KRS 61.597(7)(b). *See also* KRS 21.420(8)(b); KRS 61.635.
37 *See* KRS 16.583(7)(c); KRS 21.402(7)(c); KRS 61.597(7)(c). *See also* KRS 21.420(8); KRS 21.460; KRS 61.625.
38 *See* KRS 16.583(5)(a); KRS 21.402(5)(a); KRS 61.597(5)(a).
39 *See* KRS 16.583(5)(b); KRS 21.402(5)(b); KRS 61.597(5)(b).
40 *See* 2013 Ky. Acts, Regular Session, Ch. 120, Section 81 (SB 2).
41 *See* KRS 6.521(3)(a)1; KRS 21.405(5)(a)1; KRS 61.691(2)(a)1.
42 *See* KRS 6.521(3)(a)2; KRS 21.405(5)(a)2; KRS 61.691(2)(a)2.
43 2013 Ky. Acts, Regular Session, Ch. 120, Section 65(1) (SB 2).
44 KRS 7A.200.
45 KRS 7A.220 (1).
46 *See generally* KRS 7A.240; KRS 7A.250. Pursuant to KRS 61.645, the KRS Board of Trustees formally controls and maintains fiduciary responsibility for the Kentucky Retirement Systems.
47 KRS 7A.250(8).
48 *See* KRS 61.565(1)(b).
49 KRS 61.565(5).
50 *See* KRS 61.598; KRS 16.645(34); KRS 78.545(45)
51 *See* KRS 61.598(2)
52 *See* KRS 61.598(1)
53 *See* KRS 6.505(1)(b); KRS 16.652(2) & (3); KRS 21.480(2) & (3); KRS 61.692(2) & (3); and KRS 78.852(2) & (3).
54 *See generally* Senator Damon Thayer, "A Long-Shot Bet: Bipartisan Pension Reform Crosses Finish Line," Kentucky City, Kentucky League of Cities (June 2013).
55 *See* "Kentucky's Successful Public Pension Reform," The Pew Charitable Trusts and the Laura and John Arnold Foundation (September 2013).