



Governance, Funding, and Investments of the Kentucky Retirement Systems and the Kentucky Teachers' Retirement System

Program Review and
Investigations Committee

September 13, 2012



Report Focus

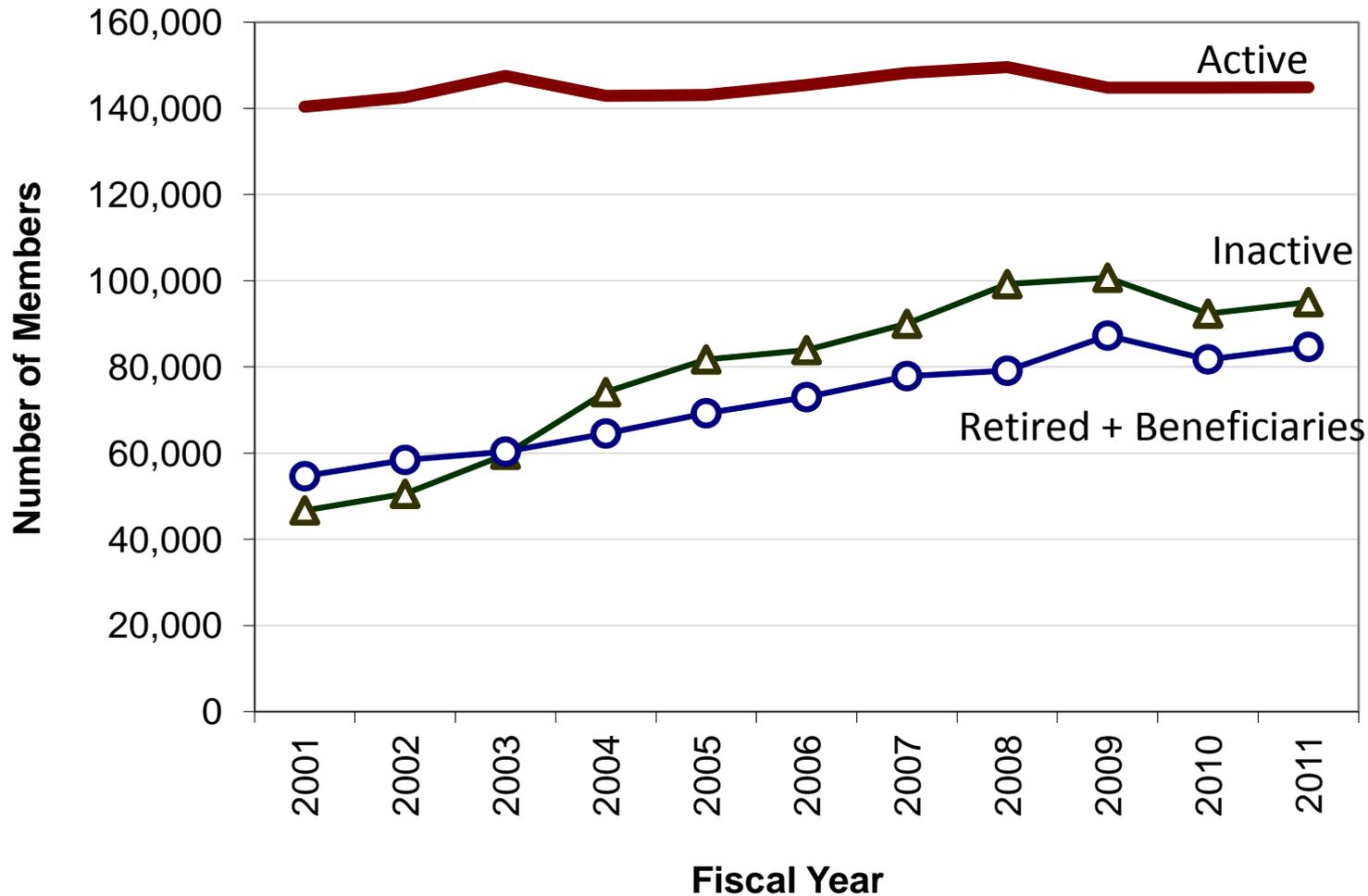
- Governance of KRS and KTRS
- Status of inviolable contracts
- KRS and KTRS funded levels and investment rates of return
- Placement agents

Overview of the Kentucky Retirement Systems (KRS)

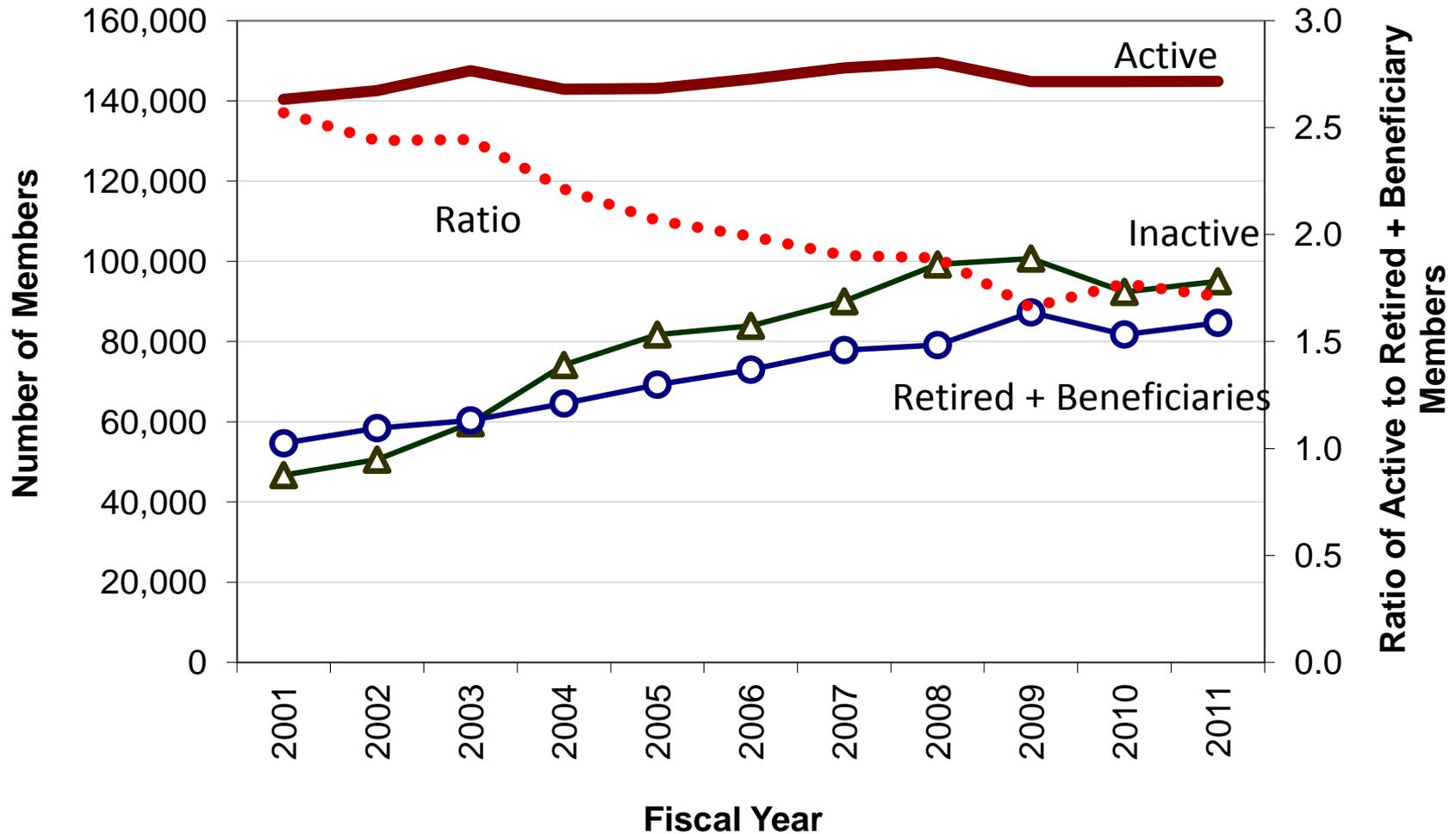


- Provides pension and insurance benefits to primarily state and local government retired members and their beneficiaries
- Three systems:
 - Kentucky Employees Retirement System (KERS),
 - County Employees Retirement System (CERS), and
 - State Police Retirement System (SPRS)

KRS Membership: 324,599



KRS Membership: 324,599



KRS Pension Recipients by Benefit Amount, FY '12



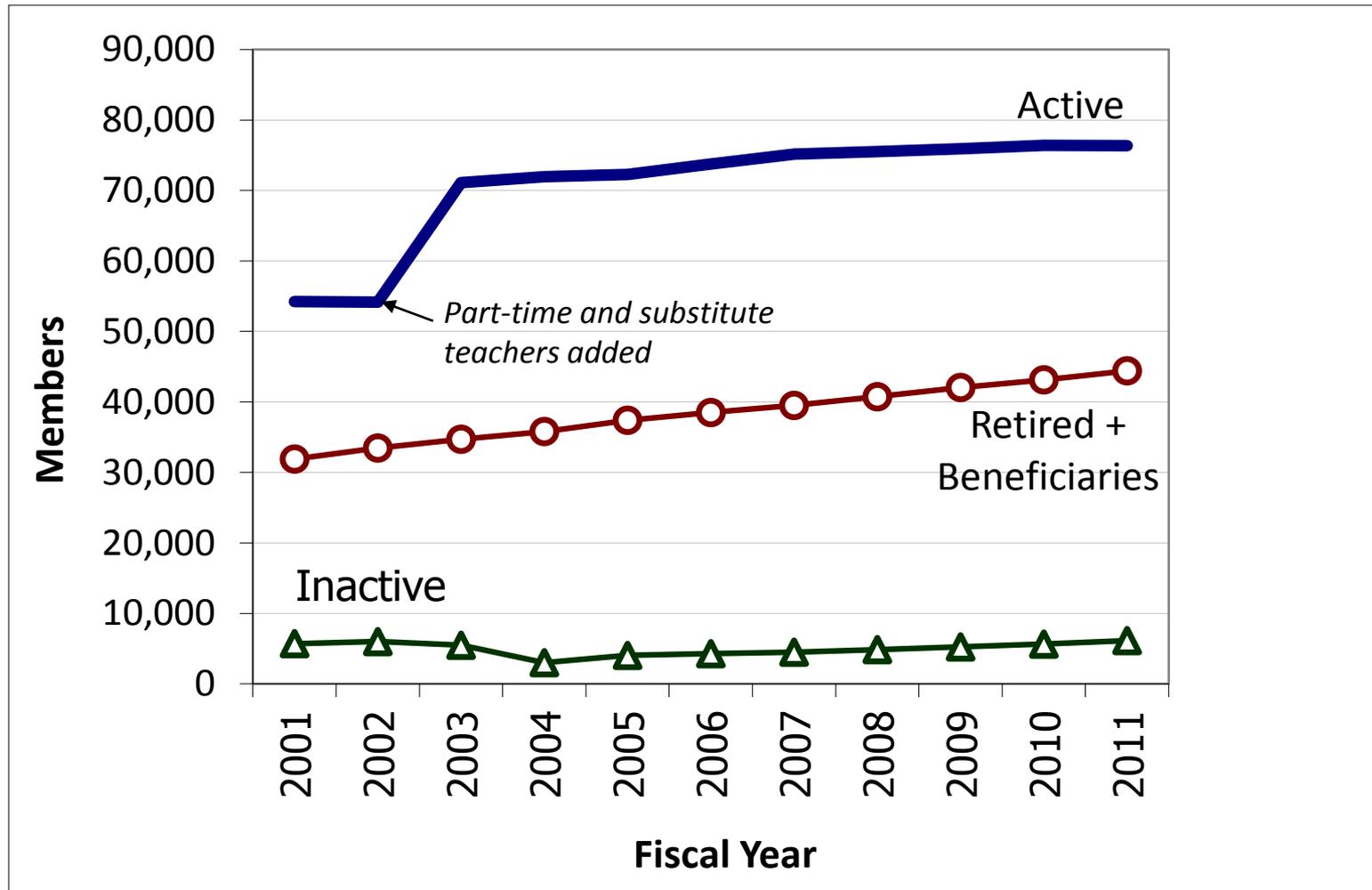
Benefit Amount (annual)	System Memberships			Total Recipients	% of Total
	One	Two	Three		
Less than \$25,000	57,626	4,461	20	62,107	73.2%
\$25,000 to \$49,999	15,713	1,941	38	17,692	20.9
\$50,000 to \$74,999	3,513	559	20	4,092	4.8
\$75,000 to \$99,999	666	121	7	794	0.9
\$100,000 to \$124,999	98	14	1	113	0.1
\$125,000 to \$149,999	14	3	0	17	0.0
\$150,000 to \$174,999	7	3	0	10	0.0
\$175,000 to \$199,999	1	0	0	1	0.0
\$200,000 or more	0	0	0	0	0.0
Total	77,638	7,102	86	84,826	100.0
Percent of Total	91.5%	8.4%	0.1%	100%	

Overview of Kentucky Teachers' Retirement System (**KTRS**)

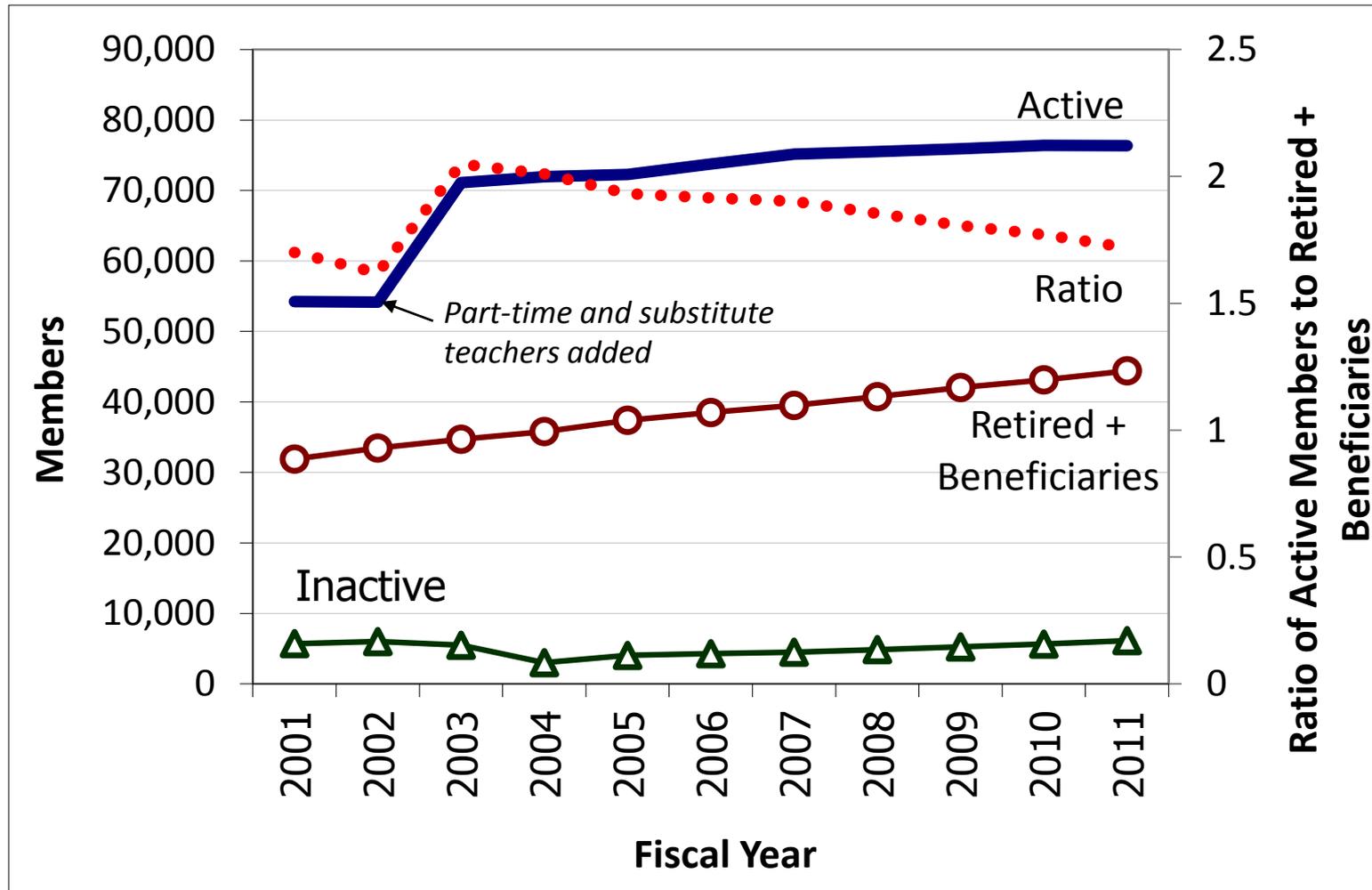


Provides pension and insurance benefits to members retired from local school districts and other educational agencies.

KTRS Membership: 126,903



KTRS Membership: 126,903



KTRS Pension Recipients by Benefit Amount, FY '12



Benefit Amount (annual)	Total Recipients	% of Total
Less than \$25,000	15,576	33.1%
\$25,001 to \$50,000	25,779	54.8
\$50,001 to \$75,000	4,961	10.5
\$75,001 to \$100,000	625	1.3
\$100,001 to \$125,000	105	0.2
\$125,001 to \$150,000	24	0.1
\$150,001 to \$175,000	4	0.0
\$175,001 to \$200,000	2	0.0
More than \$200,000	0	0.0
Total	47,076	100.0%

Organization and Governance



Item	KRS	KTRS
Board of trustees	9 trustees: 5 elected, 3 appointed, and 1 ex officio	9 trustees: 7 elected and 2 ex officio
Manager of day-to-day operations	Executive director hired by board	Executive secretary hired by board
Investment committee	5 trustees: 3 appointed by board chair and 2 with investment experience	7 committee members: 2 trustees with investment experience, 3 other trustees, and 2 investment advisors with investment experience
Investment constraints	Primarily imposed by board	Board, statutory, and regulatory limits



Legal Duties

Topic	KRS	KTRS
Trustee Training	Formal trustee education program: <ul style="list-style-type: none"> •Orientation and annual training •Incorporated by reference in administrative regulation 	
Code of Ethics	Trustees and executive staff subject to code of ethics	Trustees and staff subject to code of ethics
Transparency	Website postings required including meeting notices and agendas, <i>Comprehensive Annual Financial Reports</i> , external audits, board minutes, etc.	



Transparency

For KRS, each required document was accessible on June 18, 2012.

For KTRS, as of July 11, 2012, some information was not available:

- Benchmark for cash
- Salary and expenditure information



Recommendation 1.1

KTRS should ensure that information is posted online as required by KRS 161.250(4).

Making Changes to Pension Benefits



- Often referred to as the inviolable contract question
 - Is there a contract?
 - If yes, is it unalterable?

- Some states are changing pension benefits
 - Legal challenges in the courts often follow



Inviolable Contract

- In a number of states, public employee pension plans are considered contracts between plan members and the state government.

Inviolable Contract: Legal Foundations



- Support for the inviolability of the terms of such contracts is found in the Federal Contracts Clause and state equivalents.
- Support is sometimes also found in state statutes and case law.

Inviolable Contract: Constitutional Constraints



- U.S. Constitution, Article I, Sec. 10: “No State shall...pass any...Law impairing the Obligation of Contracts....”
- Kentucky Constitution, Sec.19(1): “No ex post facto law, nor any law impairing the obligation of contracts, shall be enacted.”

Inviolable Contract: Constitutional Constraints



- Some states have language in their state constitutions that specifically declares public employee pensions to be an inviolable contract.
 - Example: New York State
- Kentucky's Constitution does not have such a clause.

Inviolable Contract: Statutes and Case Law



- In addition to constitutional considerations, support for the inviolability of existing public employee pension plans is also found in some state statutes and state case law.

Inviolable Contract: Statutes and Case Law



- In Kentucky, each statute creating a public pension system states that it is creating “an inviolable contract of the Commonwealth.”
 - KRS 161.714; KRS 61.692; KRS 78.852; and KRS 16.652.
- Statutes may not cover changes in benefits for new employees

Inviolable Contract: Statutes and Case Law



- In some states, case law has supported the inviolability of public pension contracts.
- A 1995 Kentucky Supreme Court case supported the inviolability of the state's contract with KERS members.
 - (*Jones v. Board of Trustees of the Kentucky Retirement Systems*)

Status of Inviolable Contracts



- Recent policy changes and lower court legal cases in other states are testing the inviolability of public employee pension contracts.

Status of Inviolable Contracts



- Some states have recently made changes to public employee pension benefits.
 - For example, Arizona, Colorado, Florida, Minnesota, and Rhode Island

Status of Inviolable Contracts



- These changes have been or are being challenged in court. So far, results have only come from lower courts.
- These cases' outcomes are not binding on the Commonwealth of Kentucky.
- The cases represent just a few of the issues being litigated.

Status of Inviolable Contracts



- Some issues being litigated:
 - Can future benefits be changed for current workers?
 - At what point does an employee become a party to the contract?
 - Can required contributions by current retirement system members be increased?
 - Can COLAs be reduced or eliminated for current retirees?

Inviolable Contracts: Lower State Court Cases



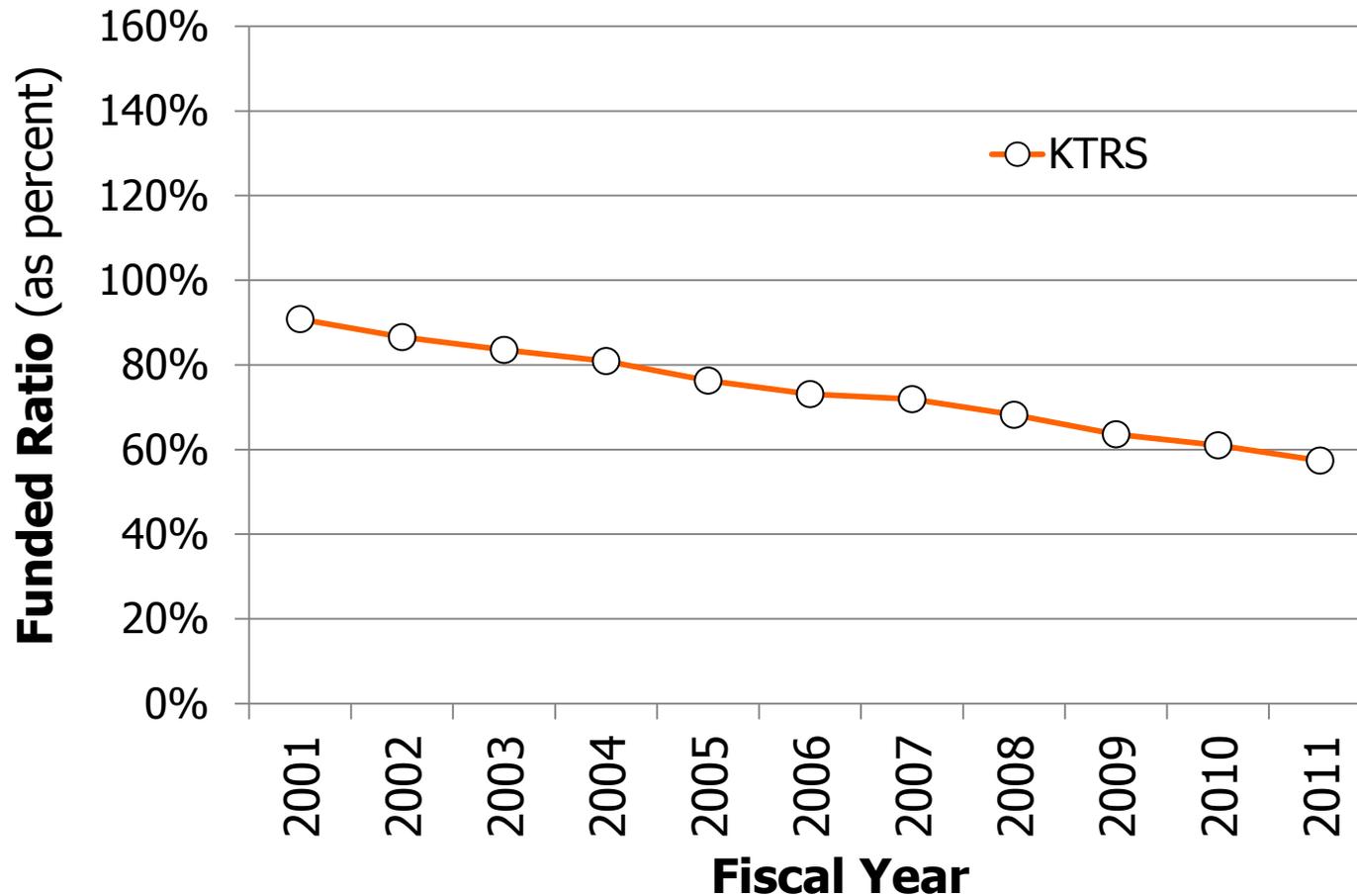
- AZ and FL: Denied an increase in contributions by current system members
- CO and MN: Allowed changes to COLAS
- FL and RI: Denied changes to COLAS
- RI: Denied decrease in retirement allowances for employees with at least 10 years in system



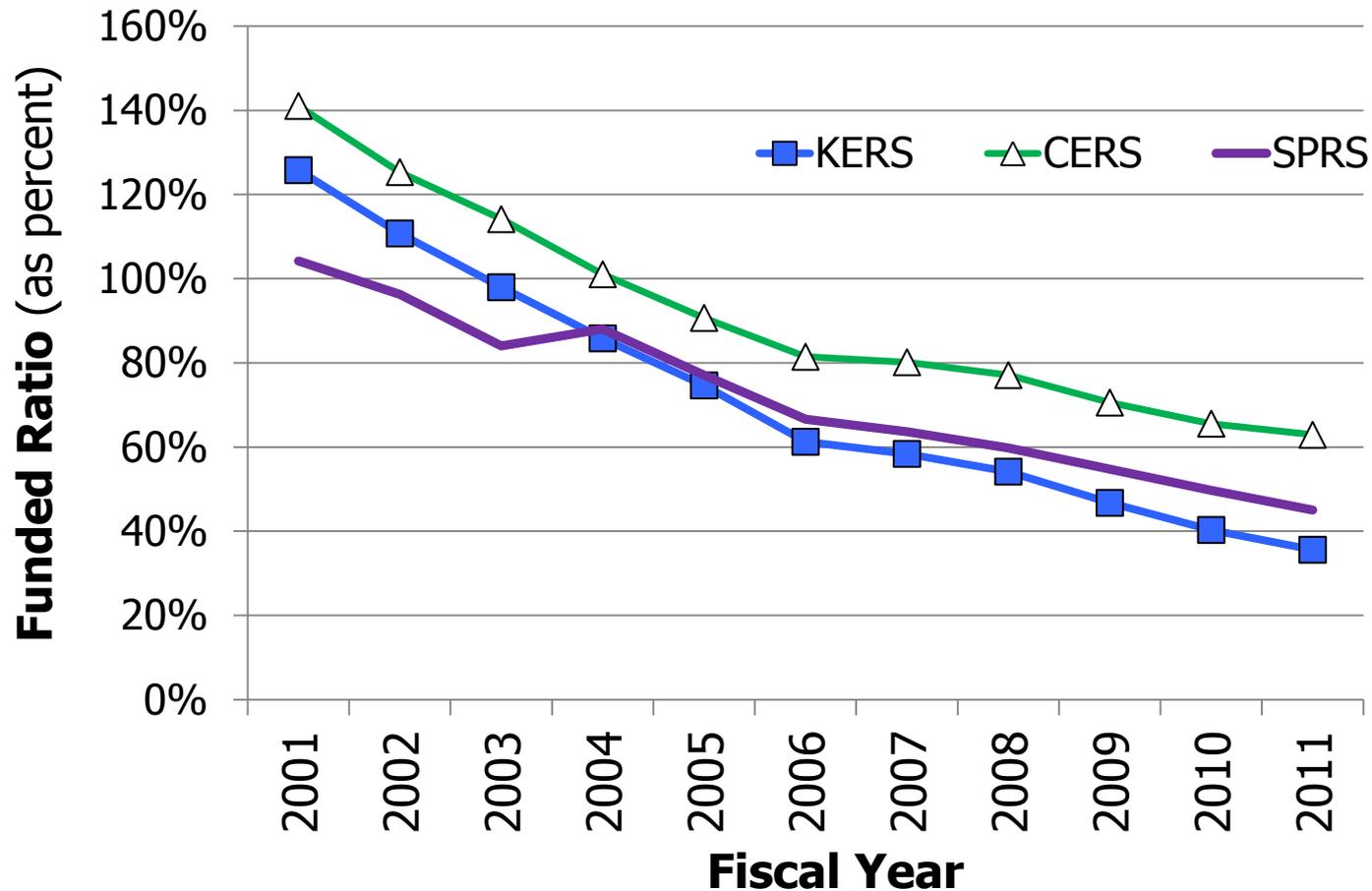
Funding and Investments

- Unfunded pension liability for FY 2011:
 - KRS: \$12 billion
 - **KTRS**: \$11 billion
- Funded levels measure a retirement system's financial status at a single point in time
 - Percentages at or above 100 indicate that a retirement system is fully funded
- Funded levels for KRS and **KTRS** pension funds have been declining in recent years

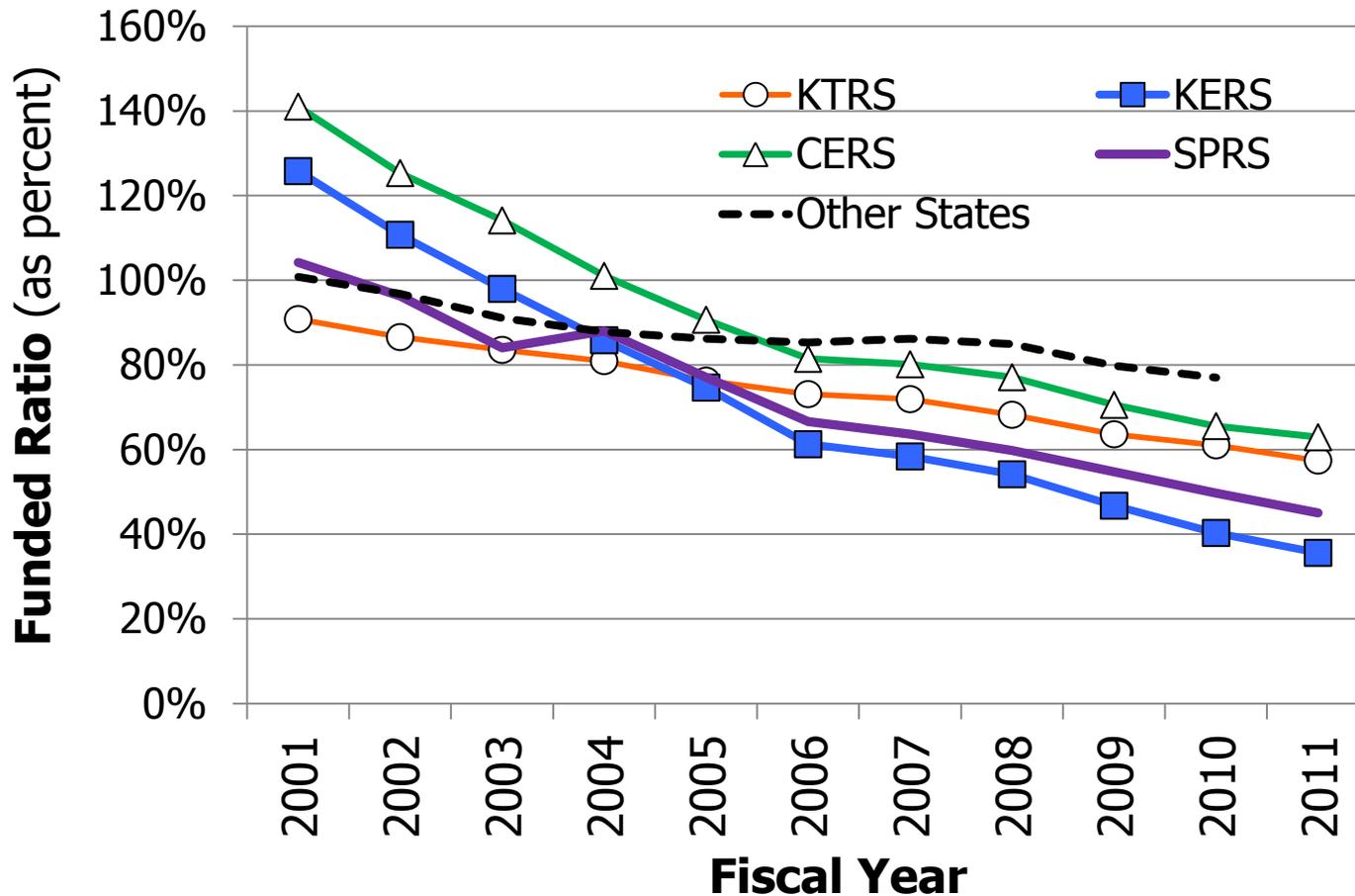
Funded Levels Falling...



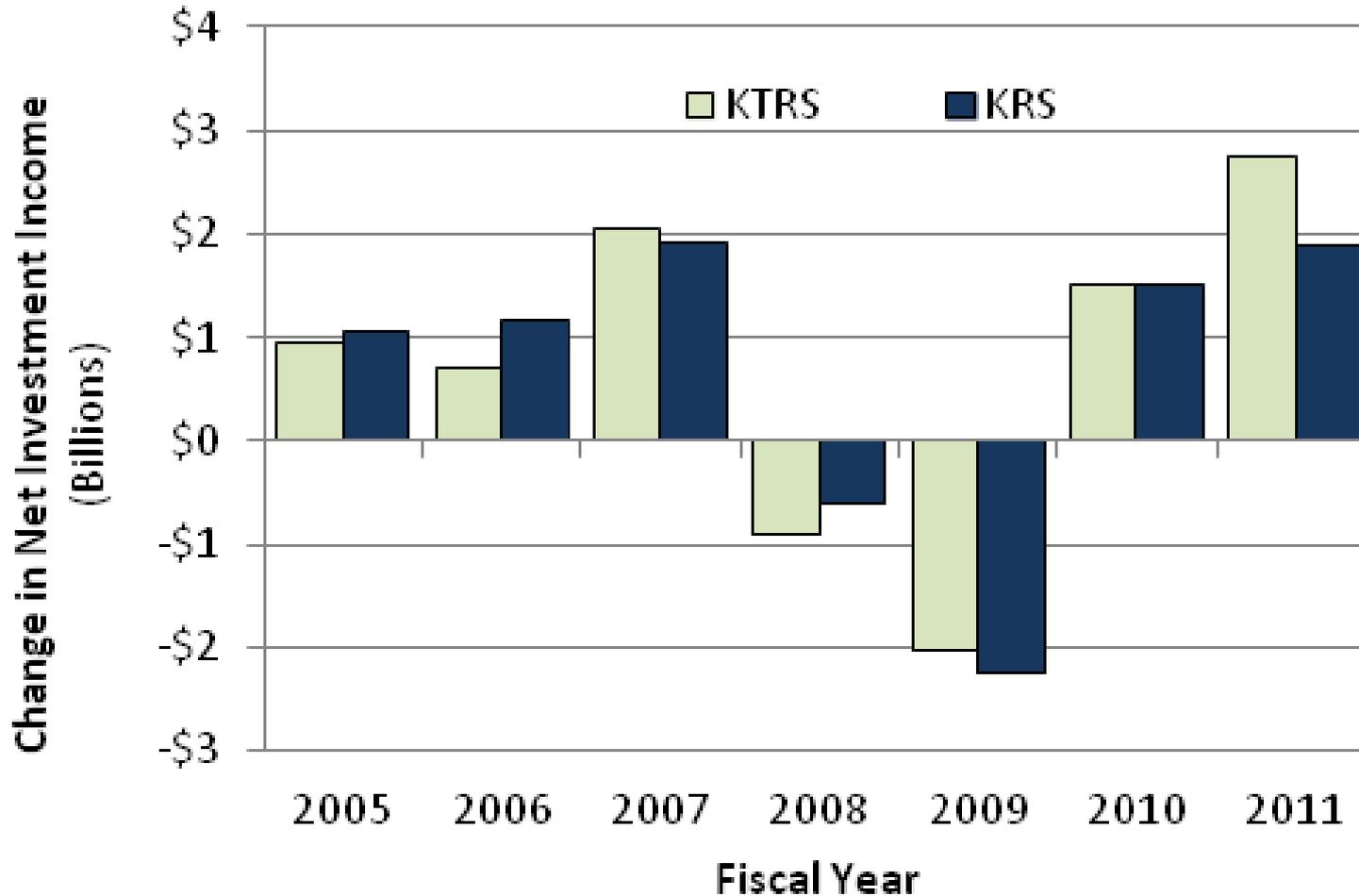
Funded Levels Falling...



Funded Levels Falling...



...Primarily Because Net Investment Income Fell



Actuarial Assumed Rate of Return



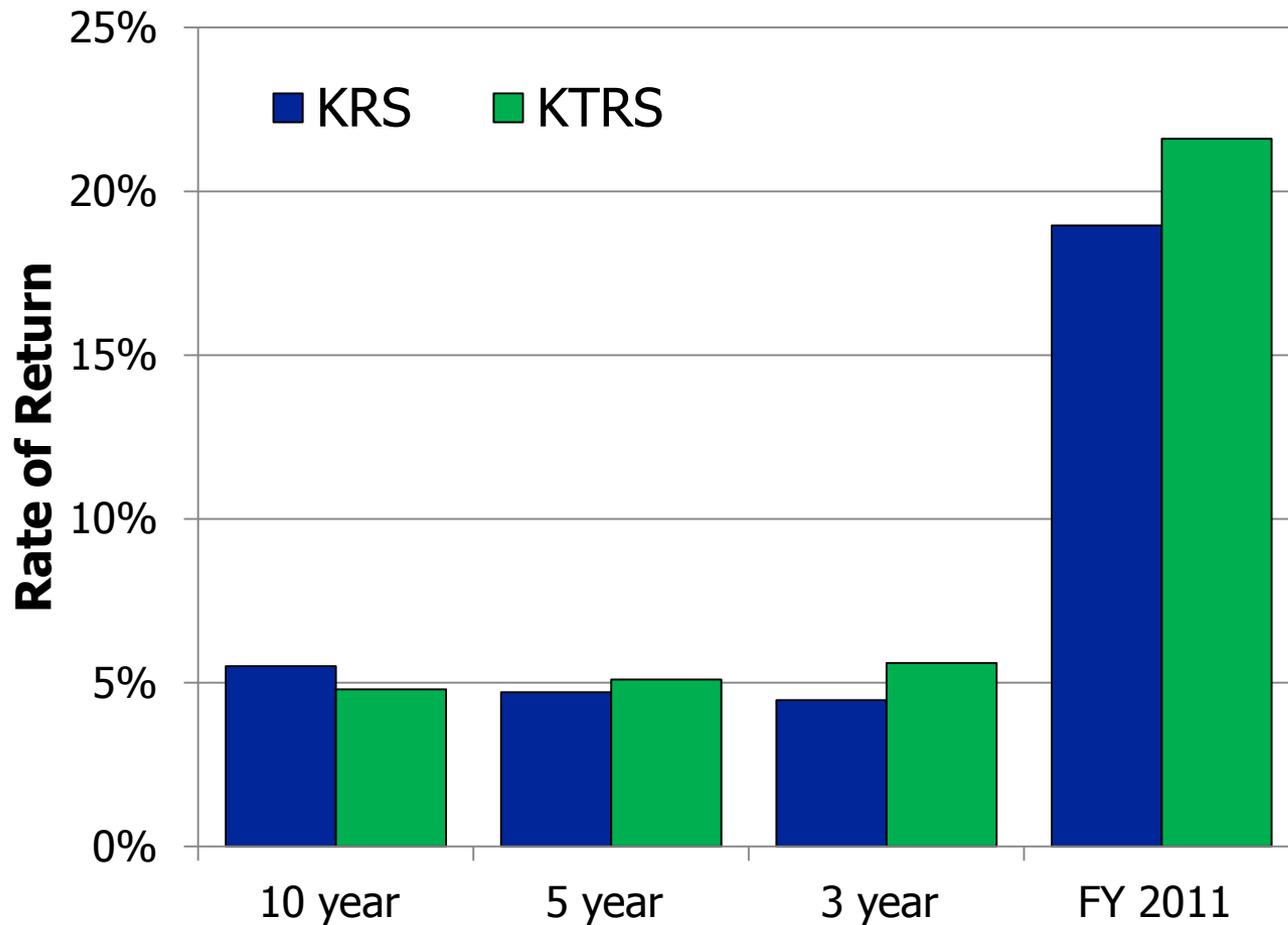
- KRS averaged 9.47 percent over previous 30-year period, outperforming 7.75 percent benchmark
- **KTRS** averaged 9.7 percent over previous 30-year period, outperforming 7.5 percent benchmark

Long-term Investment Objective

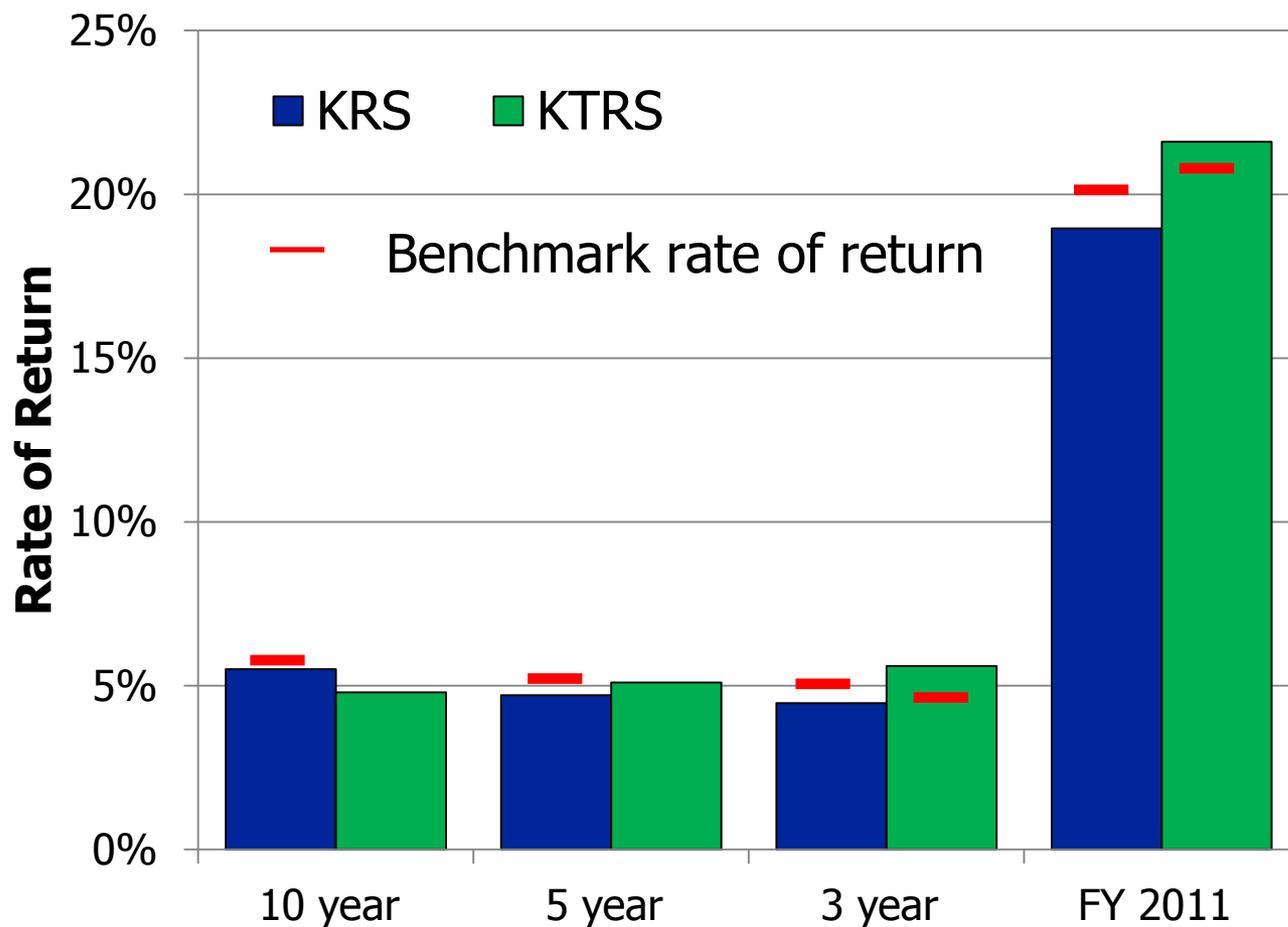


- KRS averaged 9.47 percent since inception, outperforming 7.75 percent benchmark
- **KTRS** does not provide a period of evaluation for its long-term objective, but its objective is 7.5 percent

Investment Rates of Return for Pension Funds



Investment Rates of Return for Pension Funds



KRS and KTRS Compared to National Benchmark



	BNY Mellon- Public Funds	KRS Pension Funds	KTRS Pension Fund
1-year	21.3%	↓ 19.0%	21.6%
3-years	4.4	4.5	5.6
5-years	4.8	↓ 4.7	5.1
10-years	5.6	↓ 5.5	↓ 4.8

Characteristics of Comparable Systems



	Active Members	Actuarial Value of Assets (\$ billions)
KRS (entire system)	144,894	\$11.5
16 Comparable Systems	81,870 to 225,181	\$6.5 to \$51.5
KTRS	76,349	\$14.9
12 Comparable Systems	35,855 to 105,528	\$4.1 to \$29.3

Median Rates of Return for Comparable Systems



System	1-year	3-year	5-year	10-year
KRS—Pension Fund	↓ 19.0%	4.5%	↓ 4.7%	↓ 5.5%
Median of Comparable Systems	21.0	3.8	4.8	5.6
KTRS—Pension Fund	↓ 21.6	5.6	5.1	↓ 4.8
Median of Comparable Systems	22.1	4.3	4.8	6.0

Factors That May Affect Rates of Return



- Asset allocation
 - Investment risk very important
- Investment constraints
 - KTRS has statutory and regulatory constraints
- Investment expenses
 - As percent of pension assets, KRS and KTRS expenses are lower than average of other states



Placement Agents Definition

- Placement agents are third parties that are paid a fee to secure potential investors.

Placement Agents: Concerns



- Extra costs to the pension systems
- Transparency
- Agent's self-interest if paid a fee contingent upon an investment being made

Placement Agents: Federal Rules



- At the federal (SEC) level, placement agents fall into the category of municipal advisors under the Securities Exchange Act of 1934

Placement Agents: Concerns



- A 2011 Kentucky Auditor of Public Accounts report found that a placement agent had “questionable access” to a former CIO at KRS.
- The APA made several recommendations, discussed in the study, that KRS has since implemented.

Placement Agents: Federal Rules



- The 2010 Dodd–Frank Act required all municipal advisors to register with the SEC and to abide by its rules and regulations.

Placement Agents: Other States



- In the past several years, other states have instituted a number of types of controls on the use of placement agents.

Placement Agents Kentucky Definition



- In Kentucky law, a placement agent means an individual or firm who is compensated or hired by an employer...for the purpose of influencing an executive agency decision regarding the investment of the KRS or the KTRS assets

Placement Agents: Kentucky



- House Bill 300 enacted during 2012 Regular Session requires placement agents to register as executive agency lobbyists.

Placement Agents: Kentucky



- In Kentucky, although a placement agent is a subcategory of executive agency lobbyist, a placement agent can be compensated on a contingency basis rather than a flat fee, whereas other types of executive agency lobbyists cannot.

Unregulated Placement Agents



- In Kentucky law, an unregulated placement agent means a placement agent who is prohibited by federal securities laws...from receiving compensation for soliciting a government agency.

Placement Agents: Registration Concerns



- According to SEC staff, only persons working for a person or firm and who are only soliciting business for that person/firm would not have to register.
- It is unclear whether such a person might have to register as a lobbyist in Kentucky.

Implementation Uncertainty



- Implementation of the law should be sufficiently clear.
- No consensus as to who should register as a placement agent.



Recommendation 3.1

The Executive Branch Ethics Commission, Kentucky Retirement Systems, and Kentucky Teachers' Retirement System should confer on the implementation of the sections of KRS 11A.201 dealing with placement agents and unregulated placement agents. They should report to the Program Review and Investigations Committee at its December 2012 meeting on the status of implementation and should specify recommendations for any needed revisions to the statute.



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Comparable Systems' Rates of Return: KRS



System	1- year	3- year	5- year	10- year
Massachusetts State Board of Retirement	22.4%	1.7%	4.4%	6.5%
Iowa Public Employees Retirement System	19.9	4.6	5.6	6.4
Minnesota Public Employees Retirement Assoc.	23.3	4.9	5.3	5.9
North Carolina Local Government	18.5	4.4	5.1	5.7
Nevada Public Employees Retirement Board	21.1	4.3	4.8	5.6
KRS—Pension Fund	19.0	4.5	4.7	5.5
Arizona Retirement System	24.6	5.2	4.8	5.2
Ohio School Employees	20.9	2.0	3.7	5.1
Maryland State Retirement and Pension System	20.1	3.1	4.0	5.0
South Carolina Retirement System	18.6	3.1	4.0	5.0
Mississippi Public Employees Retirement System	25.4	4.9	4.7	n/a
Oregon Employees Retirement System	22.3	3.7	5.0	n/a
Tennessee Political Subdivisions	19.6	3.8	4.5	n/a
Tennessee State and Teachers	19.6	3.8	4.5	n/a
Kansas Public Employee Retirement System	22.6	4.3	5.0	n/a
Indiana Public Employees' Retirement Fund	19.9	2.5	3.2	n/a
Washington Public Employees Retirement System	21.1	1.9	4.9	n/a

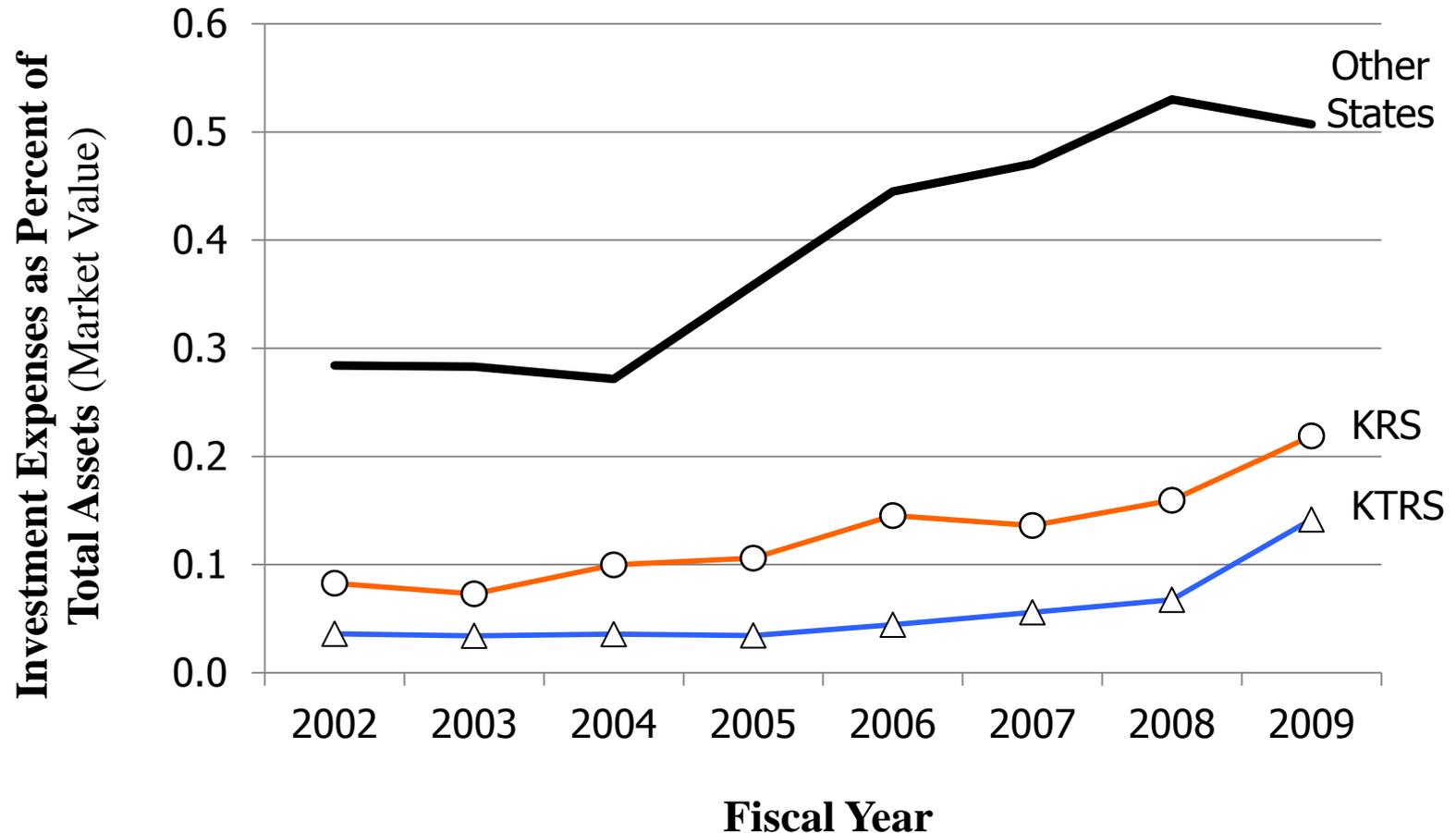
Comparable Systems' Rates of Return: **KTRS**



System	1- year	3- year	5- year	10- year
Oklahoma Teachers' Retirement System	23.5%	6.5%	5.9%	6.9%
Massachusetts Teachers' Retirement Board*	22.4	1.7	4.4	6.5
Arkansas Teachers Retirement System	22.3	4.4	5.5	6.2
Illinois State Universities Retirement System*	23.8	4.6	5.3	6.1
Louisiana Teachers' Retirement System*	26.8	3.5	4.8	6.1
West Virginia Consolidated Public Retirement Board	20.5	5.2	4.8	6.0
Minnesota Teachers' Retirement System	23.3	4.9	5.3	5.9
Connecticut Teachers Retirement Board*	20.1	4.2	4.8	5.5
New Mexico Educational Retirement Board	19.7	5.3	5.2	5.5
Missouri Public School Retirement Board*	21.8	3.6	4.3	5.4
Maryland Teachers' Retirement System	20.0	3.1	4.0	5.0
KTRS*	21.6	5.6	5.1	4.8
Indiana Teachers' Retirement Fund	18.0	3.4	4.2	n/a

* Retirement systems with the majority of members not covered by social security (Boston College. Database).

Investment Expenses as Percent of Pension Assets



Funded Levels Falling...

