October 23, 2017

Dear Members of the General Assembly:

Please find enclosed a letter sent today by Kentucky League of Cities Executive Director Jonathan Steiner to the governor on behalf of the Board of Directors and city members of KLC. Our Board of Directors also voted to share this communication and the accompanying list of questions and concerns with the members of the General Assembly. Please take some time to consider these issues as you provide input and analysis as a bill is developed and considered.

We commend the governor and members of the General Assembly for having the fortitude to aggressively address one of our state's most pressing fiscal issues. We recall the difficulty in 2013 when we worked together to find consensus on this issue. Potential solutions are challenging to obtain because of the various political, legal and financial issues that impede the easiest routes. From a city perspective, the framework released last week provides a sound point for beginning more detailed discussions about the final version of possible reform.

KLC's job has always been and continues to be to provide information and advocacy on behalf of the elected leaders of Kentucky's city governments. Because of both the practical and policy implications that this legislation will have on our communities, we want to be sure its impact on the basic functioning of our cities, their employees and, most importantly, their citizen taxpayers remains an important factor in the forefront of developing a final bill. As always, we are committed to working together to support legislation that will help city governments and our state advance.

KLC's Board of Directors has not taken any position on the proposed legislative framework. As we get more answers and see proposed bill language, it will put our organization in a better place to determine whether the bill has a net positive or a net negative impact on city governments. KLC's Board of Directors will vote to take a position at that point.

Thank you for continuing to work with us on behalf of our cities so that each of Kentucky's communities can reach their full potential to help advance our entire Commonwealth.

Sincerely,

James D. Chaney

J.D. Chaney
Deputy Executive Director, KLC

Bryanna Carroll
Governmental Affairs Coordinator

October 23, 2017

The Honorable Matt Bevin
Governor
Commonwealth of Kentucky
700 Capitol Avenue, Suite 100
Frankfort, KY 40601

Dear Governor Bevin:

I am writing to you at the instruction of the Kentucky League of Cities Board of Directors. On behalf of KLC's members, thank you for engaging with our organization to discuss pension reform. Because of its direct impact on city governments, the status of our pension system has been a top area of focus for KLC over the past 15 years. KLC collaborated with state government officials to help craft and advocate for multiple reform efforts during that time, including the most recent comprehensive changes in 2013. Even in this last regular session, KLC led the effort to finally pass legislation that capped pension benefits of employees in instances of spiking abuse. As an organization representing employers that are trustees of limited taxpayer dollars, KLC has always taken a balanced approach to pension reform that also recognizes the contributions of the dedicated public servants that deliver city services.

Thank you for personally meeting with KLC and the other employers participating in CERS last week in the minutes following your press conference. As you requested, the KLC Board of Directors has met to consider the two options for pension reform that you presented. Option A was for local governments to immediately begin payment of the dramatically increased contribution rates resulting from the KRS Board's action in July, and Option B was to support the plan framework without the actual bill language or financial analysis. Rather than endorsing either of these options, the KLC Board of Directors voted instead to support a third option: to continue in its efforts to find common ground with state policy makers that will yield solutions that put city governments in the best possible position to provide the critical services that are essential to the progress of our entire Commonwealth.

Your willingness to make your team, including Director Chilton and Chief of Staff Brickman, available for conversations with KLC's representatives after the release of the PFM report at the end of August has been helpful and is very much appreciated. During these discussions KLC put forth ideas for dedicated revenue sources for pension funding; attempted to discuss conditions that would address apprehension about CERS separation; provided actuarial analysis of changes to the hybrid cash balance plan that would possibly be cheaper, continue to pay down the unfunded liability, and maintain more equity between hazardous and nonhazardous employees; suggested exploration of prospectively removing COLAs only for retirees who were reemployed; expressed support of the concept to address the remaining benefit spiking issues; encouraged exploration of provisions that would increase employee contributions for pension benefits; and expressed support for language to address the failure of the KRS Board to better implement or phase-in changes to actuarial assumptions that have dramatically increased employer contributions.

While several questions and concerns about the plan were addressed in previous meetings, several remain unanswered or are otherwise unresolved. Therefore, KLC has not yet taken a position to either support or oppose the proposed framework. Our Board feels that it would be premature to take any position in the absence of the actual bill language without any financial or actuarial analysis. Since you and your staff have offered to continue to address the questions and concerns, please find attached to this letter a list of questions to help obtain additional information that will be necessary for KLC members to effectively evaluate the proposal.

The KLC Board of Directors is also concerned about the S&P analysis released on October 19. The statement from this independent financial rating agency that the debt ratings of municipalities in Kentucky could be pressured as a result of the proposed changes is particularly troubling. The analysis recognizes that the "increase in employer contributions could particularly pressure the finances of cities…" We have attached this analysis for your information and hope that some consideration of the anticipated impact is considered as the final bill takes shape.

Lastly, in previous discussions with KLC you indicated that you were agnostic about the idea of separating CERS from the Kentucky Retirement Systems. KLC's Board voted in June of 2015 to make this a legislative priority and continues to believe that it needs to be part of pension reform. As you know, local governments have not had any control of the structure of benefits designed by the state or the plan management of local funds by the KRS Board of Trustees but have faithfully met their obligations every year. It's undeniable that the management of the system has much to do with the fact that CERS does not have a better funded ratio. Obtaining management that has a focused fiduciary obligation to the local system with a governance structure providing some independence and insulation from the political process is essential to ensuring success and stability in the years to come for local governments. It is difficult for local leaders to continue to put their faith in a state-controlled system that has failed their cities and their employees.

Again, we applaud you and legislative leaders for continuing to try to put the state's financial house in order by tackling this issue. We know that it is a difficult task. Please understand that city officials across the state that are entrusted to a local office share your goal of Kentucky being the best version of itself. However, for that to occur, our communities must also remain functioning and capable of providing the services that are indispensable in providing a standard of life that supports economic growth now and for future generations. Great cities make a great state. We look forward to working together with you and members of the General Assembly as the legislative process moves forward on this and other important issues.

Respectfully,

Jonathan J. Steiner

Jonathan Steiner
Executive Director/CEO

c: Members of the Kentucky General Assembly
Chief of Staff Blake Brickman

Phase-In of the Actuarial Required Contribution for CERS employers

- Why was a period of four years selected rather than something more similar to the example given in the PFM report, which limited the increases in contribution rates to no more than 10 percent from one fiscal year to the next? The preferred approach would be to make this transition more stable and less dramatic from one year to the next.
- It seems counter-intuitive to adopt an ARC that is equivalent to this fiscal year's contribution rates when, even before the KRS board's dramatic change in assumptions, the rate was predicted to increase in the next fiscal year (to 19.57percent for nonhazardous and 32.50percent for hazardous). This appears to be a step back in terms of the principles that state policy makers have been advancing for pension reform. We should begin the process of phasing in changes in the upcoming fiscal year.

Paying Off the Unfunded Liability

- Is the understanding correct that adopting a level dollar amortization method doesn't, by itself, change the fact that the liability will still be paid down through employer contributions on current reported payroll in the absence of other statutory changes?
- For the past several weeks KLC has asked for details about the concept frequently referenced in meetings that will establish a mechanism to provide for flat payments by each participating employer of its proportional share of the total unfunded liability over the new 30-year amortization period. Is this provision going to be based upon the GASB methodology currently used by KRS in determining the net pension liability of each employer?
- Will the statutory method result in an accurate calculation of the share of each employer's true liability to the system? For example, an employer who started participation within the last three years certainly would have a much different level of responsibility to the system than one that has been in since cities were forced into the system in 1988.
- Would this process differ between hazardous and nonhazardous plans in CERS since the defined benefit plan is proposed to be closed for nonhazardous and not for hazardous duty?
- How would these payments change if there was a change in either the assumed rate of return or the rate of inflation?
- Will this change permit employers to pay down its proportional share of the unfunded liability more quickly? For example, in the same manner an individual with a mortgage can generally pay off the debt sooner or make extra payments?
- How stable would these payments be if they were made? For example, could there be increases later? What would the impact be on the system if several employers made this choice, greatly increasing the funded ratio of the systems?
- Can you share your legal analysis regarding the implications on Section 158 of the Kentucky Constitution if a mechanism is created to assign proportional liability is developed? Would it not be considered debt for the purposes of that section? The grant of authority to the General Assembly (GA) provides that it is subject to the limits and conditions of the section and elsewhere in the constitution and authorizes the GA to set additional limits and conditions, but is not an authorization for the GA to be less

restrictive or serve to authorize the GA to let local governments exceed its terms. Therefore, if a statutorily assigned debt is spelled out in statute and required to be paid, the only way to avoid application of the provision is that that assignment would not constitute debt for purposes of the constitutional provision. If it does constitute debt, what are the consequences to local governments that would exceed the limits – legal or otherwise? If so, how many local government employers could be placed in this position?
- If these funding methodology changes to statutorily assign proportional liability were made in statute could the repayment period be for a longer period without violating actuarial practice and standards?

Information on Cost Savings Anticipated by Changes

- What is the actuarial analysis on whether the 27 year cap in Tier I (rule of 87 in tier II) on accruing additional benefit factor increases on nonhazardous duty employees positively impacts the unfunded liability or could it have the opposite impact of having people retire earlier and receive benefits longer than many otherwise would have?
- Is there any intention of rolling back years of service for individuals working that have more than 27 years on July 1, 2018? In other words, are those individuals entitled to keep what they have earned in years of service and benefit factor enhancement and are they put into defined contribution (DC) only for work performed after July 1, 2018?
- Can you provide actuarial analysis, financial predictions, or even estimates on what the total value of the changes to the unfunded liability in the pension systems will be with the proposed changes? Can it be broken into component parts showing the value of each piece or provide a description of why they would have to be combined because of overlap? At a minimum, it is possible to decouple the total pension unfunded actuarial liability (UAL) savings with the insurance UAL change through increased employee contributions. Can you provide actuarial analysis, financial predictions or even estimates for the UAL reduction in the insurance fund by the increase in employee contributions?
- What is the change in the funded ratio for CERS if these proposals are adopted under the current applicable assumptions?

Information Related to Contribution Rates for CERS Employers

- Can you provide a copy of the contribution rate predictions for employers in CERS that will occur if every provision of the bill is adopted, including the reset of the amortization period, transition to level dollar methodology, and other changes to employee benefits? Can you provide this information broken down by the pension fund and the insurance fund?
- Can you provide a comparison of predicted employer contribution rates both with and without the phase-in to demonstrate the impact the proposed four year phase-in period?

Nonhazardous Duty Employees Hired After January 1, 2014 in a DC Plan

- Are there reasons other than the complete elimination of risk for the adoption of the defined contribution plan for nonhazardous employees? Is this why the proposal recommends a defined contribution plan with higher nominal costs (5percent) than the current hybrid cash balance plan (4percent).

- We have frequently heard the reason for this change is that the current hybrid cash balance plan is not sustainable. This is confusing since the decision has been made to maintain the defined benefit plan for hazardous duty employees. Is there a financial argument for the distinction that it is sustainable for one group and not the other?
- What are the costs associated with transitioning from the hybrid cash balance plan to a DC plan?
- Was there consideration given to making adjustments to the hybrid cash balance plans to further reduce employer risk rather than creating a great division between hazardous and nonhazardous employees by including those employees in entirely different types of plans?
- Doesn't the transition to a defined contribution plan eliminate the potential for paying down the unfunded liability given the investment sharing on returns above 4percent (or modified amount) provided under the current plans?
- If an alternative methodology for paying unfunded liability is not or cannot be developed (see questions above about this change) and can only be based on the percent of current payroll, then will the proposal require employers to make additional contribution on the unfunded liability for those participating in a defined contribution plan (similar to what occurs now with those in the hybrid cash balance)? If not, doesn't that create a disincentive for hiring and retaining individuals in employment positions that began participating with employers before January 1, 2014?
- The new defined contribution plan would be managed by Kentucky Deferred Compensation. The entity is governed by a board of seven individuals all appointed by the governor and there are no representatives of employees or local governments employing these individuals. This worsens that lack of adequate representation that was one of the reasons KLC began its advocacy for CERS separation.
- Is there an intention to make transparency and ethics provisions and other rules that are currently applicable to the retirement systems that exist in statue or were mandated under Senate Bill 2 passed during the 2017 regular session applicable to the system?
- What changes are being made to the statutes governing the Kentucky Deferred Compensation system in the legislation?
- If the defined benefit plan is being shut down and new mandatory defined contribution plan is being created with an alternative method for paying down the unfunded liability, did the architects of the pension proposal consider permitting local governments to develop their own defined contribution plans at levels they can afford or they deem competitive to attracting employees rather than continuing to send its funds to the state? Local governments can competitively negotiate their own management fees as well, which could result in cost savings. Local governments not participating in CERS can do this now as well.
- Does the defined contribution plan go into effect upon the 1st of the following month after the full unreduced retirement eligibility date is reached? Does this happen automatically?
- Is there a required vesting period for those moved to the defined contribution program?
- Are the employees in the new defined benefit eligible for a form of disability should they become disabled?

Health Insurance

- Is the employee requirement for health insurance a total of 3percent across all tiers or is it 3percent additional for employees in Tier II making their contribution for health insurance 4percent?
- Is there an intent to place the new employee insurance contribution requirement on employees in Tier I that were hired before July 1, 2003 and has there been an analysis of whether such a requirement for those participants has implications related to the inviolable contract?
- Is the same level of health insurance benefit maintained for employees in the new DC plan? Will that fund also be managed by Deferred Comp or will it be managed elsewhere?
- If the employee resigns prior to retirement eligibility, is the 3percent forfeited, like the 1percent for Tier III's?
- If the employee that is in the $10 per service year plan contributes 3percent for the health insurance fund and can't afford the monthly premiums by the time they reach retirement ($27 x 10 = $270 compared to CURRENT costs leaves the retiree paying >$400 at today's premiums), will they be entitled to a refund?
- For future retirees, is their health insurance offering frozen at 27 years (Rule of 87) or is it just the monthly pension benefit?
- What safeguards are being considered to ensure the state does not raid the public employee health fund again to meet future obligations?
- If employees have to pay an additional 3percent for the healthcare fund then is there a guarantee of coverage and lower costs for this contribution?

Rehired Retirees

- Is there intention on impose the same rehiring prohibitions on legislators as it would apply to other nonhazardous duty employees?
- What happens with those rehired retirees who are working on July 1, 2018? Are those individuals considered "grandfathered" and permitted to continue working without penalty?
- What happens with employees rehired under the provisions of KRS 95.022, rehired law enforcement officers by city police departments, for one year periods? Are those individuals working on the effective date of the act permitted to continue under the same terms? Is there a change when the one year contract may be renewed after July 1, 2018?
- Is there any intention of changing the current rules applicable to retired individuals engaged in contract services with participating employers in one of the systems?
- Because of the hiring and training issues related to law enforcement, the difference between hazardous and nonhazardous duty are understandable – but several law enforcement officials will retire from nonhazardous and will be ineligible for rehire without waiver of their benefit. Also, this impacts specialized jobs that are difficult to fill or require extensive training and certification, such as water and wastewater operators. The provision could create major issues with compliance and operation of these utilities if personnel cannot be found or afforded because of the manner in which the proposal addresses nonhazardous duty retirees.

- For hazardous duty retirees who must pay normal costs contribution (along with hiring employer) to the system from which the employee retired, which normal cost will be used, the normal cost the retiree had (Tier I or Tier II) or the hybrid cash balance normal cost? What is the logic in paying the costs to the system from which the individual retired instead of to the system in which the employee is hired because it is the system in which they are hired that is missing the contributions as a result of rehiring a retiree?

Changes in Creditable Compensation and Service Credit Calculation

- Will the manner in which use of sick time is addressed to prohibit the use for service credit after July 1, 2018 result in a great number of retirements which may cause serious administrative and financial issues for local governments, especially in the areas of law enforcement?
- What is the number of CERS employees that are potentially eligible for retirement on or after July 1, 2018 with the use of accrued sick time?
- If the policy forces a number of retirements, could that be a negative cost impact by essentially incentivizing people to retire earlier and draw benefits longer? Is there any analysis of whether this behavior can be expected and its potential cost impact?

Other Issues

- Does the elimination of air time apply on a prospective basis only and not apply to individuals who have already purchased and are actively working on July 1, 2018?
- Is the proposal for a governing investment board as outlined in the PFM report included within the legislation?
- What is the loophole closed to ensure line of duty death benefits for hazardous duty?

S&P Global Ratings

(/en_US/web/guest/home)

Kentucky Releases Pension Reform Framework Ahead Of Special Session To Address Escalating Costs

19-Oct-2017 14:24 EDT

View Analyst Contact Information

NEW YORK (S&P Global Ratings) Oct. 19, 2017--Kentucky Governor Matt Bevin and legislative leaders released a pension reform framework ("Keeping the Promise") ahead of a special session this fall to address the state's escalating pension costs.

Absent reform, these costs are projected to increase nearly $700 million in fiscal 2019, pressuring the state's already-strained budget. Most local governments are not immune to the increase, with their annual payments expected to increase by 50%-60%. Kentucky has already taken some steps to address plan solvency in 2017, such as more realistic plan assumptions and commitment to funding in excess of the actuarially determined contribution (ADC). These changes, combined with a history of weak funding discipline, are responsible for increasing pension costs in the next biennium. As we noted in our report (/en_US/web/guest/article/-/view/sourceId/9943351) on Jan. 11, 2017, when S&P Global Ratings revised its rating outlook on the state (A+ issuer credit rating) to negative from stable, "The state's ability to fund these obligations within a structurally balanced budget is a key consideration for the future of the state's credit quality."

The comprehensive framework outlines several measures, including paying the full ADC for all plans, moving new "nonhazardous" employees and teachers to a 401(k)-style defined-contribution plan, suspending current cost-of-living adjustments (COLAs) for current teacher retirees for five years, and leaving the pensions of "hazardous" employees mostly unchanged. We positively view the proposals to move all plans to a more conservative funding policy based on level-dollar amortization to end the backloading of plan contributions and allow outside agencies, nonprofits, and universities the ability to fully fund their promised benefits and cease participation in the retirement system within two years.

While the framework does recognize the limitation of benefit changes to active members and current retirees, any enacted pension changes will likely face legal challenges. Kentucky Revised Statutes 161.714, known as the inviolable contract, states that benefits shall not be subject to "reduction or impairment by alteration, amendment, or repeal." As seen in other states, legal challenges to pension reform can take years to resolve, and courts may invalidate the largest cost-saving measures. If enacted reforms are ultimately invalidated, this may have negative credit implications as the state would need to need to make up those costs.

A statutory requirement to fund 100% of ADC only to the Kentucky Employee Retirement System (KERS) plans started in 2015. Due to liquidity concerns, the state increased these contributions above requirements (known as "ARC plus") in fiscal 2017 and 2018. The state contributed $58.2 million above the ADC in fiscal 2017 to KERS' nonhazardous employees' plan, $25 million to the state police plan, and $15 million to KERS hazardous employees' plan. As a result, the state is contributing a little over 110% of the KERS nonhazardous ADC in fiscal 2017. However, the state's largest plan (Kentucky Teachers' Retirement System, or KTRS), continues to be annually funded at less than 100% of required contributions. If enacted, the proposals to suspend COLAs and begin paying 100% of required contributions to KTRS should substantially improve plan funding and eliminate the plan's 2039 depletion date projected under Governmental Accounting Standards Board Statement No. 67.

Pension contributions make up a sizable share of Kentucky's budget. Total commonwealth contributions from all funds are $2.08 billion for fiscal 2017 and 2018. The share coming from the general fund accounts for 13.8% (fiscal 2017) and 13.2% (fiscal 2018) of spending. Absent reform, the state estimates that pension costs for the general fund would increase nearly $700 million in fiscal 2019, up 6% from fiscal 2018's appropriations. Other funds will also be affected, such as the Road Fund, which also has payroll costs for employees covered by KERS. The fiscal 2019 increase amounts to annual required increases of 66.7% for KERS nonhazardous, 88.5% for KERS hazardous, and 71.9% for state police. Given current budgetary and economic conditions, absorbing these increases over the next biennium will be challenging.

These increasing costs are compounded by reliance on reserves in the current biennium, reduced expenditures, and revenue underperformance. To increase pension contributions in the 2017-2018 biennium budget, various agencies' funding were reduced by 9% and funding for public colleges and universities were reduced by 4.5%. The budget also drew on $106 million of budget reserve trust fund balances and applied $187.5 million per year of one-time excess revenues from the self-insurance fund. While we view increases in pension funding as a positive step toward addressing the state's large unfunded pension liabilities, the use of reserves is not sustainable.

Estimated fiscal 2017 year-end revenues were $135 million less than anticipated, however the state used a budget reduction order to address the shortfall without tapping reserves. Unfortunately, the revenue landscape for fiscal 2018 has not improved, with a similar shortfall already identified. The governor has already requested most state agencies to prepare plans to cut their budgets by 17% ($200 million), however this request is likely to be reduced due to recently improved revenue estimates showing a shortfall closer to $155 million. In addition, the governor has requested additional reductions to restore $150 million to the state's emergency rainy-day fund, which is expected to be depleted during the year. Updated revenue forecasts are expected in December.

Adding to Kentucky's budget stress are projections that its economic indicators will lag the nation, on average, over the next four years, according to IHS Markit. Key measures such as total employment, population growth, and personal income growth show a potential softening of its tax base that could make absorbing higher fixed costs more difficult. In the current biennium, Kentucky made broad-based budget cuts, but from both a policy and political perspective, further cuts in these areas may prove difficult. We anticipate continued slow economic growth, which will limit tax revenue growth. A likely increase in other costs could inhibit natural growth from addressing rising pension costs. Continuing revenue underperformance further complicates the state's efforts to achieve structural balance.

The effect on local governments will not go unnoticed. The increases in pension contributions could particularly pressure the finances of cities, which carry a higher pension costs than counties and school boards. Although we understand local governments have some revenue raising flexibility, property taxes among others, it is unclear if sufficient revenues could be raised by fiscal 2019. Municipalities with nominally low reserves would be especially vulnerable to precipitous expenditure increases. In general, with pension cost rising across the commonwealth, the debt ratings of municipalities could be pressured. Administered by the Kentucky Retirement System, the majority of local government units participate in the County Employees' Retirement System (CERS) plan.

Successful pension liability management is an ongoing process, not a point-in-time solution. The state's pension woes did not occur overnight and are the result of years of underfunding. The proposed framework will be drafted into a bill for consideration at a special session this fall. It is uncertain to what extent the proposed measures will achieve legislative approval and be enacted into law. Ultimately, the state's ability to adopt meaningful and credible pension reform--that withstands legal challenges--to adequately fund its obligations within a structurally balanced budget will be critical to its future credit quality.

```
S&P Global Ratings, part of S&P Global Inc. (NYSE: SPGI), is the world's
leading provider of independent credit risk research. We publish more than a
million credit ratings on debt issued by sovereign, municipal, corporate and
financial sector entities. With over 1,400 credit analysts in 26 countries,
and more than 150 years' experience of assessing credit risk, we offer a
unique combination of global coverage and local insight. Our research and
opinions about relative credit risk provide market participants with
information that helps to support the growth of transparent, liquid debt
markets worldwide.
```


Primary Credit Analyst:	Timothy W Little, New York (212) 438-7999; timothy.little@spglobal.com (mailto:timothy.little@spglobal.com)
Secondary Contacts:	Carol H Spain, Chicago (1) 312-233-7095; carol.spain@spglobal.com (mailto:carol.spain@spglobal.com)
	Jessica Akey, Chicago 312-233-7068; jessica.akey@spglobal.com (mailto:jessica.akey@spglobal.com)
	Todd D Kanaster, ASA, FCA, MAAA, Centennial 303-721-4490; Todd.Kanaster@spglobal.com (mailto:Todd.Kanaster@spglobal.com)