



Kentucky Retirement Systems

PPOB Administrative Subcommittee CERS Separation

David Eager, Executive Director

March 2019

OPTIONS REGARDING CERS SEPARATION

1. Continue as is- KRS has one Board and one administrative operation
2. Establish Boards for CERS and KERS/SPRS to oversee actuarial, investment and related issues
 - KRS Board continues to be responsible for all other aspects of KRS
 - Keep one administrative operation intact
3. Completely separate CERS from KRS
 - Operates totally independent
 - Implemented over time

CURRENT GOVERNANCE

KRS Board of Trustees: 17 Trustees

- 10 appointed by the Governor
 - 7 directly appointed
 - 3 from lists submitted by the League of Cities, KACo, and the School Board Association
- 6 Elected by the KRS membership
 - 3 CERS
 - 2 KERS
 - 1 SPRS
- 1 Ex-Officio: Secretary of the Personnel Cabinet
- Must have six (6) investment professionals (SB2 2017)

CURRENT GOVERNANCE

Board Committees:

- Board elects a Chair and Vice Chair
- Five (5) Committees:
 - Investment (9 members)
 - Actuarial Subcommittee (7 members)
 - Audit (7 members)
 - Retiree Healthcare (5 members)
 - Disabilities/ Administrative Appeals (2 committees, 3 members each)
 - Perimeter Park West Board (3 members)

KRS ANSWERS TO THE 10 QUESTIONS

1. 2. 3. Cost Comparisons?

-Option 1 \$47 mil annual budget

-Option 2 \$47 mil + some additional expenses

-Option 3 \$47 mil + an estimated \$7 mil +

KRS ANSWERS TO THE 10 QUESTIONS

4. How Would The New Board Be Composed?

- These questions should be answered CERS representatives (a,b,c,d,e,f)
- Size of the Board?
 - Large enough to get broad perspective
 - Not so large to be cumbersome
 - Should include at least two investment professionals

KRS ANSWERS TO THE 10 QUESTIONS

5. Governance of the New Board?

- Actuarial
 - Assumptions
 - Experience Studies
 - Annual Valuations
 - Special Calculations
- Investment
 - Policies and Objectives
 - Asset Allocations
 - Managers
- Other?

KRS ANSWERS TO THE 10 QUESTIONS

6. How Would Current KRS Board Change?

- Under option 2:
 - The KRS Board would continue but not be responsible for investments and actuarial requirements
- Under option 3:
 - Six Board members would leave and likely be replaced

KRS ANSWERS TO THE 10 QUESTIONS

7. Duplication of Administrative and Consulting Services with Two Boards?

- Option 2- Some
 - Board Chair, actuary?, investment consultant?, legal, CIO, etc.
- Option 3- complete

KRS ANSWERS TO THE 10 QUESTIONS

8. Can We Create a CERS Board While Maintaining KRS Administration?

- Option 2 does that

KRS ANSWERS TO THE 10 QUESTIONS

9. How to Promulgate or Amend Regulations?

Option 2: Each of the three Boards would address regulations that affected them

Option 3: Each of the two Boards would address regulations that affected them.

KRS ANSWERS TO THE 10 QUESTIONS

10. Any Trend for Consolidation?

- Not that we see for Boards
- There are many states which have consolidated their investment offices or have always had a single investment office for multiple systems/agencies

KRS's PERSPECTIVE

- Prefer option 1- the status quo

KRS operates efficiently and effectively

- Cheapest of the 3 options
- Avoids duplications

KRS responds to differing systems' needs

- Assumptions
- Investment policies and asset allocations

No disruptions

KRS's PERSPECTIVE

- Option 3 is problematic and unnecessary

Greater cost to the tax payers

- Redundancies would likely increase operating costs at least \$7 mil
- Loss of some negotiating and scale leverage

Would cause disruptions

- Staff displacements
- Systems programming
- Unwinding investment and other contracts
- External support changes (e.g. accountants, actuaries, investment consultants and many other providers)
- Facilities
- Communications materials
- Etc.

KRS's Perspective

Option 2 Could be an Acceptable Alternative if Properly Organized

1. Have equal authority and responsibility for the KERS/SPRS Board and the CERS Board
2. Have most members of the two Boards be members of the KRS Board
3. Maintain as much of the current administrative and operational structure as possible
4. Minimize disruptions as a result of any changes
5. Minimize cost increases

OPTION 2



OPTION 2

KRS BOARD: 17

CERS Board



Investment
Department



KERS/SPRS Board

- Outside Resources
 - Consulting Actuary
 - Investment Consultant
 - Outside Legal Counsel
- Inside Resources
 - Executive Director
 - CIO
 - Other

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APPENDIX



Kentucky Retirement Systems

CERS SEPARATION ANALYSIS

David Eager, Executive Director

Oct 22, 2018



KEY TAKEAWAYS

- **KRS runs efficiently**
- **Running two separate systems will cost more than one system alone...and will cause transitional issues and disruption**
- **Having a CERS Board governing CERS investments and actuarial assumptions would be a less costly and disruptive alternative**
- **KERS Non Haz's poorly funded position does not negatively impact CERS investment management**

How Effectively Does KRS Operate – Background

Peer Comparisons Are Difficult

- **KRS includes investment staff and related expenses in our administrative expenses - unlike our peers**
- **KRS administrative expenses include the administration of five health care plans. Many peers do not offer health coverage**
- **KRS administers a highly complex pension system with 3-4 benefit tiers and multiple sub tiers (ex: insurance contributions; bifurcated pension contribution rates; hazardous & non-hazardous plans). Members have reciprocity with other state systems. There are 1,490 reporting agencies. Benefits will become less complicated as member populations transitions to Tier 3, but impact at least 10 years away**
- **KRS staff (245 associates) are in the KERS Non-Hazardous plan with increasing employer contribution rates (5.89% in 2001 vs. 49.47% in 2018)**

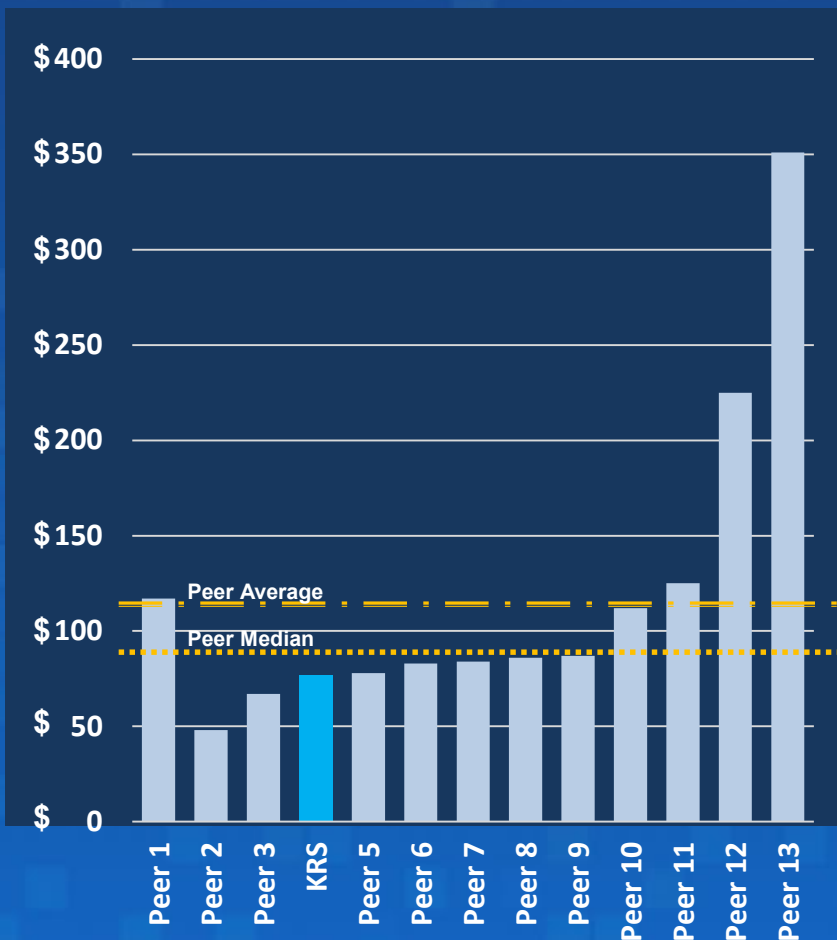
How Effectively Does KRS Operate – Background

Peer Comparisons Are Difficult

- Employee turnover rates of over 15% (IT turnover at 20%) are problematic for KRS
- KRS updated our technology system (START) in 2011. KRS owns the source code, resulting in lower external vendor support expenses and the ability to implement legislative mandates in-house (ex: Tier 3; pension spiking)
- KRS participated in the 2016 CEM benchmarking study. KRS administrative costs were \$35 per active member and annuitant **lower** than our comparable peer group

CEM BENCHMARKING DATA

KRS total *pension* administration cost was \$77 per active member and annuitant. This was \$35 below the peer average of \$112 (and \$7 below peer median of \$84).



Reasons why KRS total cost was \$35 below peer average	
1. Economies of scale advantage	\$ (1.50)
2. Lower cost per member	(4.89)
3. Lower transactions per FTE	3.67
4. Lower cost per FTE for salaries, benefits, building, utilities, HR, and IT	(10.97)
5. Lower third-party and other costs in front-office activities	(5.78)
6. Lower cost for back-office activities	
-Governance and Finance	(5.18)
-Major Projects	(3.56)
-IT strategy, database, applications	(3.82)
-Actuarial, Legal, Audit, Other Support Services	(2.80)
Total	\$(34.83)

2016 CEM Benchmarking Inc.

KRS Administrative Expense Overview

Administrative Costs - 5 Year History (\$ in Millions)						
	KRS Expenses Benchmark to Peers	Investment Staff +	Health Care Administration +	Pension Contributions +	KRS Total Expense =	Staff Annual Turnover
2014	\$20.4	\$2.3	\$6.6	\$3.5	\$32.8	8.6%
2015	\$17.2	\$2.2	\$6.2	\$5.4	\$31.0	11.4%
2016	\$18.2	\$2.3	\$6.5	\$5.7	\$32.7	7.3%
2017	\$17.9	\$2.4	\$6.7	\$6.7	\$33.7	13.7%
2018	\$17.2	\$2.3	\$6.3	\$6.5	\$32.3	15.3%
		Additional KRS Administrative Expense				

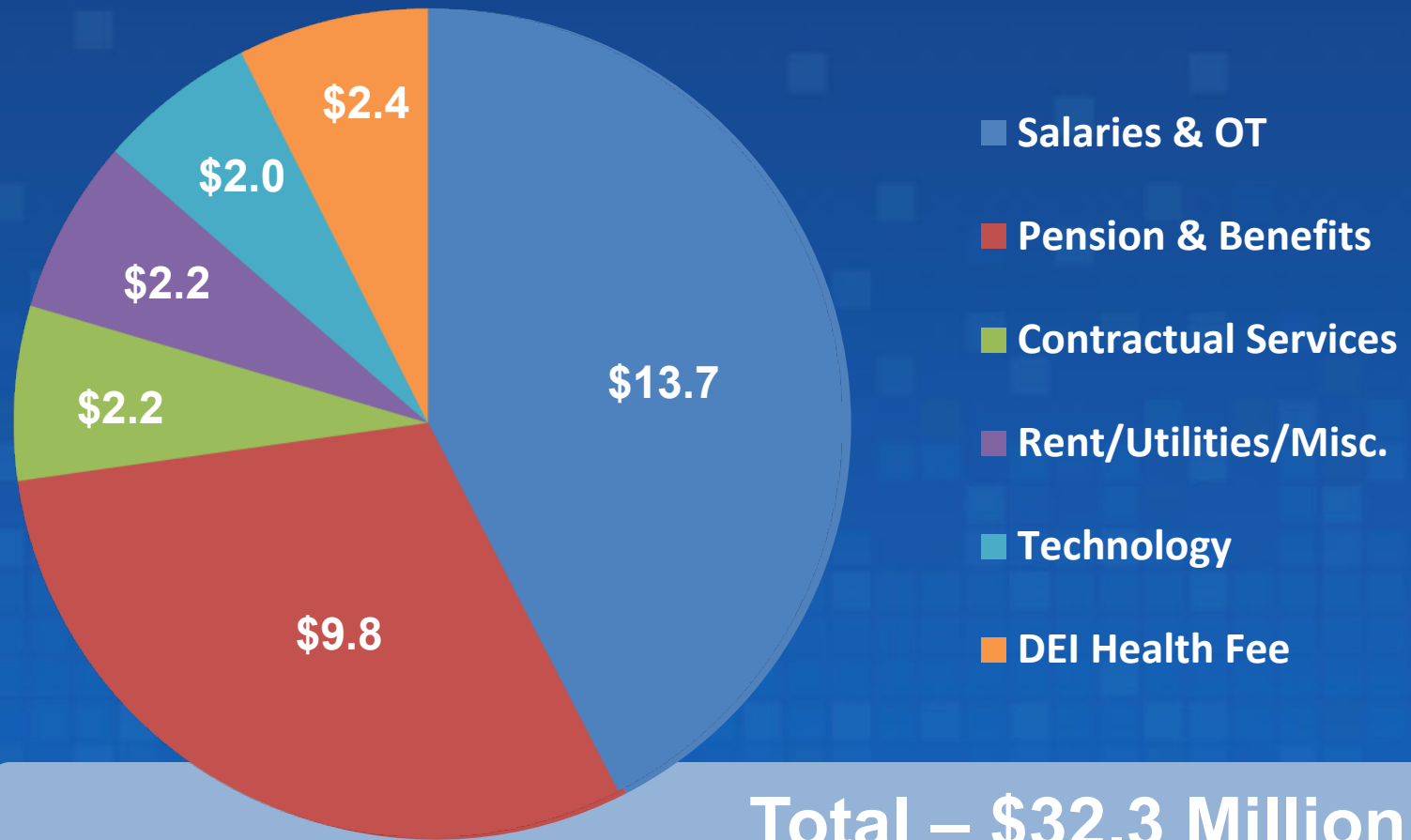
Allocation by System

KRS Administrative Expense Allocation (based on membership counts) <i>\$ in Millions</i>					
	KERS	CERS*	SPRS	TOTAL	
2014	\$12.4	\$20.2	\$0.26	\$32.8	
2015	\$11.5	\$19.2	\$0.25	\$31.0	
2016	\$12.0	\$20.4	\$0.23	\$32.7	
2017	\$12.3	\$21.2	\$0.24	\$33.7	
2018	\$11.6	\$20.5	\$0.23	\$32.3	

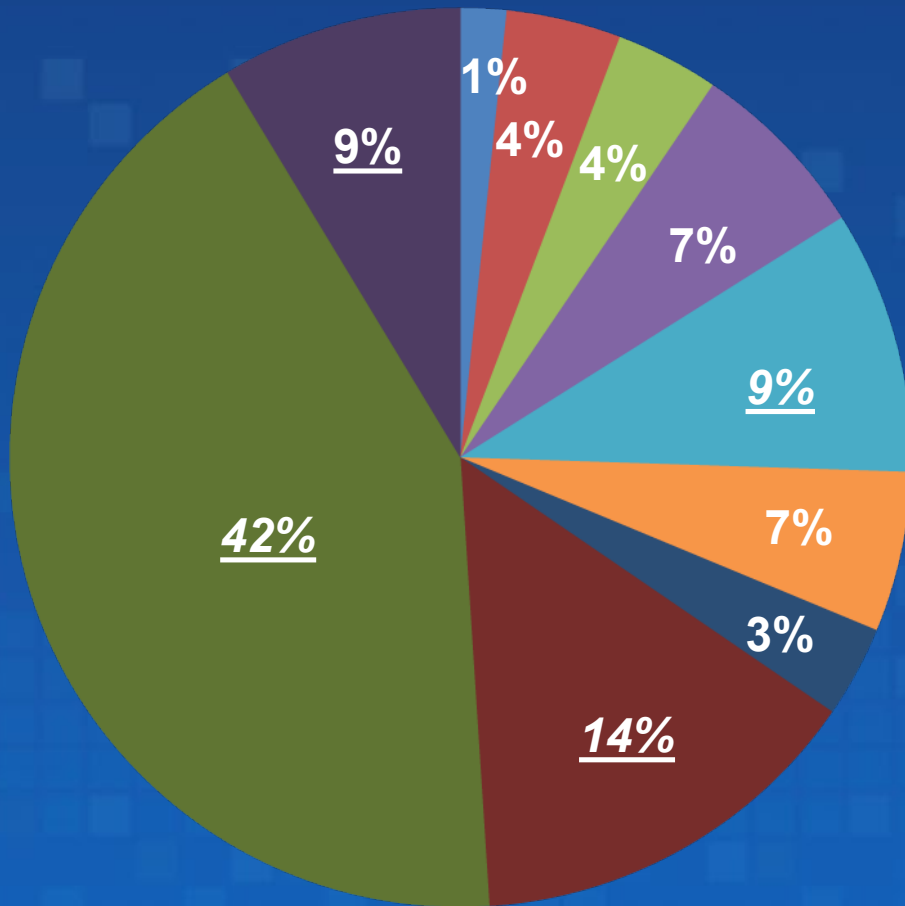
*CERS = 62%-63%

KRS 2018 Administrative Expenses by Category

(\$ in Millions)



Counselors & Technology = 74% of Staff



STAFFING = 245 Personnel Cap = 270		
@ 6/30/18	#	%
Executive	4	1%
HR/Audit/Communications	10	4%
Investments	9	4%
Legal	16	7%
Employer Reporting	23	9%
Office Services	16	7%
Accounting	8	3%
Technology	35	14%
Benefits/Counselors	103	42%
Health Care	21	9%

CERS Separation



SCENARIO 1

- CERS has its own Board that sets actuarial assumptions and investment policies for CERS plans
- KRS Board oversees all other aspects and management of KRS. Continues to include CERS members

SCENARIO 2

- CERS and KERS/SPRS totally separate over a period of time

CERS Separation Considerations

Considerations	Scenario 1	Scenario 2
	<i>CERS - Separate Board</i>	<i>CERS – Total Separation</i>
Governance	CERS Board of Trustees (how many/who)	CERS Board of Trustees (how many/who)
		Separate Personnel policies (KRS under 18A)
		Disability/Administrative Appeals Committees
		Other Committees (Audit, Retiree HealthCare, Investments)
	Bylaws	Bylaws
	Board and Management policies	Board and Management policies
	Liability insurance	Liability insurance
	Administrative regulations	Administrative regulations
Legal & Consulting		New legal entity contracts
		Dedicated legal counsel (fiduciary requirements)
		IRS tax rulings
		Trusts and custody agreements
	Investment Advisor	Investment Advisor
		Investment manager agreements
	Legal consultants	Legal consultants
		Audit services
Actuarial services	Actuarial services	

CERS Separation Considerations

Considerations	Scenario 1	Scenario 2
	<i>CERS - Separate Board</i>	CERS - Separate Trust
Personnel		Separate Needs
Financial/Technology		Converts from Plans to Trusts (Pension and Insurance)
		Contract Management (KRS 45A Model Procurement)
		Investment custodial bank
		Buildings - rent and assets
		Retiree Healthcare risk pool (DEI, Humana)
		Actuarial assumptions (e.g. mortality)
		Separate Administrative budget
		CAFR/SAFR
		Financial audits and GASB reporting
		START modifications
		Code replication
		Separate licenses or usage seats
Member/Employer Services		Benefit complexity as pension and health plans diverge
		Benefit materials
		Member forms

Separate Trusts – Summary Level Expense Estimates

Category/Cost Estimate	One-Time Cost Low to High (\$ thousands)		Additional On-going Low to High (\$ thousands)		Description
Investments					
Custodial Fees (volume change)			\$1,000	\$1,200	Review of BYN Mellon reported regulatory fees, asset adm, transaction fees & services. Both KERS and CERS impacted by scale/volume
-Investment Manager Fees (volume change)			\$900	\$1,100	Based on review of investment classification and fund investments pricing tiers. Both KERS and CERS impacted by scale/volume
Investment Consultant, Legal, Audit			TBD	TBD	Total cost could remain the same or increase
Technology					
Module Development	\$770	\$1,170			Replication of START Code and determine operating models (10-15% of IT costs).
Disaster Recovery/Business Continuity	\$1,300	\$2,900			To separate infrastructure, hardware would require duplication. Hardware is not always defined by size but also by function. KRS has 200 servers not because the size is too big for 100 servers, but because software often requires its own server to function securely and efficiently
Consulting	\$350	\$450			Develop Trust reciprocity models and reporting
System Licensing & Services Duplication			\$310	\$750	Variable products based on usage or seats - between 10% to 25% of IT average spend
Governance, Legal, Consultants					
Fiduciary Insurance for additional Board			\$100	\$200	Based on Board membership, investment risk, active litigation
Contract Separation/legal hearings	\$25	\$75			Range based on work being performed internally or externally
Actuarial, Audit			TBD	TBD	Board choice to use same or differ
Member Services					
Forms Redesign/Printing	\$25	\$50			Printing of legal documents and forms
Member Booklets/Video	\$65	\$75			Volume changes for Open enrollment/1099 forms
Website Design/ Support	\$25	\$30	\$4	\$10	Create new website/on-going vendor support/distributions
Total	\$2,560	\$4,750	\$2,313	\$3,255	

Total Separation Staffing Considerations

Staffing Duplications beyond current 245 positions
(\$ in thousands)

Additional Title	Base Salary	Pension Rate 21.48%	FICA/Ins Other Benefits 22.80%	Total	# of Positions
Executive Director (Agency Head)	\$200	\$43	\$46	\$289	1
Chief Operations Officer	150	32	34	216	1
General Counsel (Ex Dir Office of Legal)	110	24	25	159	1
Administrative Support (Executive Assistant)	45	10	10	65	1
Chief Benefits Officer	110	24	25	159	1
Human Resources Director	96	21	22	139	1
Technology Director (Info Officer)	120	26	27	173	1
Infrastructure Manager	102	22	23	147	1
Information Security Analyst	73	16	17	105	1
Investment Professionals/Operations	745	160	170	1,075	5
Compliance Officer	55	12	13	79	1
Sr. Staff Accountant	58	12	13	84	1
Internal Audit Professional	51	11	12	74	1
Total	\$1,915	\$411	\$437	\$2,764	17

NOTE: KRS as employer, pays KERS NHZ pension contribution. CERS staffing split, would pay the CERS rate. Costs will shift, but obligation remains the same.

Will the staff required to run two systems be equal to the 245 administering KRS TODAY?

Separate Trusts – Cost Summary

Expense Estimate (\$ in thousand's)		
	Low	High
One Time Set-up	\$ 2,560	\$ 4,750
On-going Expenses	\$ 2,313	\$ 3,255
On-going Management	\$ 2,764	\$ 2,764
On-going Estimated Total	\$ <u>5,077</u>	\$ <u>6,019</u>

Recent Questions

Q. Since the introduction of SB 226 in 2017, any discussions with groups regarding CERS separation?

A. Many general discussions, but not centered on CERS separation.

Q. Has KRS discussed with employer groups, belief there is fiscal advantages to outsourcing?

A. Previously, but not since their recent presentation.

Q. After a 5-year transition period what would happen to the KRS staff?

A. Many would likely be hired by CERS

- **Others would retire or find other employment during transition period**
- **Other would remain with KERS/SPRS**
- **KRS would lose a lot of talent and “history”**
- **Transition period should be shorter**

Recent Questions

Q. Can you address the point made by the employer groups that KRS' last experience study left out CERS data?

A. The 2008-2013 experience study included all plans. An audit of the experience study was completed by Segal Consulting in 2015 which included all plans. Both are on the KRS website.

<https://kyret.ky.gov/About/Board-of-Trustees/Pages/Experience-Studies.aspx>

Q. Address the 247% increase in administrative costs experienced by KRS over the last 15+ years?

A. 247% is correct.

2001 to 2018 annualized administrative expense growth = 5%

Membership growth = 3%

Inflation = 2%

Net adjusted expense growth rate = 0%

During period, KRS employer pension/insurance contributions increased from 5.89% to 49.47% and represented 20% of our administrative costs.

Recent Questions

Q. Does KRS Commingle Plan Investments?

- A. Yes, often to make block investment purchases
- No, once the shares go to BYN Mellon (our custodian bank)
 - It is against federal law to move assets from one trust to another to pay benefits
- Example:

Investment Committee approves the purchase of \$100M publicly traded company (excluding KERS NHZ & SPRS Pension Plans)

<u>INITIAL STEP</u>	Publicly Traded Investments (\$ in thousands)		
The manager is given the full amount of the approved funding in the amount \$100,000	KNHZ	0.0%	
	KHAZ	4.0%	4,000
	CERS	46.0%	46,000
	CHAZ	16.0%	16,000
	SPRS	0.0%	
	KINS	6.0%	6,000
	KZNS	4.0%	4,000
	CINS	15.0%	15,000
	CHNS	8.0%	8,000
	SINS	1.0%	1,000
		100.00%	\$100,000

<u>INCREASE IN MARKET VALUE</u>	Publicly Traded Investments (\$ in thousands)		
Due to favorable market conditions the value of the investments have increased by \$5,000.	KNHZ	0.0%	
	KHAZ	4.0%	4,200
	CERS	46.0%	48,300
	CHAZ	16.0%	16,800
	SPRS	0.0%	
	KINS	6.0%	6,300
	KZNS	4.0%	4,200
	CINS	15.0%	15,750
	CHNS	8.0%	8,400
	SINS	1.0%	1,050
		100.00%	\$105,000

Recent Questions

Q. Would the state still remain liable for the CERS share of the unfunded liability were a separate CERS board or any participating employer to become insolvent?

A. If any participating employer became insolvent, the remainder of the participating CERS employers would be responsible for the provision of benefits. KRS cannot state with any certainty if the Commonwealth would be liable for the CERS share of the unfunded liability if CERS as a whole became insolvent. This would ultimately be a question left to the courts.

Recent Questions

Q. Regarding a “more” rather than “less” consolidated system, can KRS explain the system in Tennessee and how it is different from KRS?

- A. Tennessee (TCRS) consolidated seven systems (ex: teachers, state, local employees) under the State Treasurer in 2014.
- The plans provide pension, disability, and death benefits (no health insurance).
 - Administration for TCRS is provided from state agencies including information systems, accounting, management services, human resources, and internal audit. Administration expenses were approximately \$19 million for the period ending June 30, 2017
 - There is one investment office managing all seven systems. Investment Staff expenses are recorded in the Trust, **not included in administrative fees.**

Compliments *From EMPLOYERS:*

- *Glad there was an in-person training for participants and reporting officials. Hope to see those returning on a reoccurring basis.*
- *ERCE training was excellent. I was very pleased that they went through all the tabs on the website.*
- *A member wanted to pass along his thoughts concerning his conversation with an ERCE representative. He said that she was “totally awesome, professional, courteous” and the we were “blessed” to have her working here.*
- *I wanted to share with you that an official from a city agency raved about how kind, patient, and helpful ERCE staff has been over the past few months while she has been trying to learn more about the laws, taking care of reports, correcting errors, and researching invoices.*
- *I just received a call from a member who wanted to pass along how wonderful their conversation with an ERCE representative was today. She stated that the KRS employee was very kind, took her time and explained everything clearly, and did an overall great job in assisting her. She said that we have an awesome employee.*

Compliments *From MEMBERS:*

Re: Call Back Assist: "I recently used this opportunity and was extremely impressed by the quickness of the return call and the PROFESSIONALISM of the individual who assisted me in my questions. FINALLY, an agency that TRULY RESPECTS its members & provides actual assistance when needed."

"A beneficiary of a member came into the office today." He spoke with me and wanted to pass along how good of a job we did and that we were really nice and helpful here at Kentucky Retirement Systems."

*"I want to recognize you for all of your assistance. I want your supervisor to know how much you changed our lives. Our family wants to formally thank **KRS Counselors** for assisting/making a miracle happen to keep my husband's benefits on track. I am at work headed to hospital in a little while, but wanted you to know how grateful we all are for all of your hard work and willingness to go the extra mile. It gave us the best Christmas we could have had despite keeping my husband in Hospital. Still a long way to go but knowing his insurance and benefits are intact take such a load off my mind."*

KEY TAKEAWAYS

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- **Running two separate systems will cost more than one system alone...and will cause transitional issues and disruption**
- **Having a CERS Board governing CERS investments and actuarial assumptions would be a less costly and disruptive alternative**
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