Kentucky Pension FAQs

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How many state-run public pension systems are in Kentucky?

Three. The Teachers' Retirement System (TRS), Kentucky Retirement Systems (KRS) and the Kentucky Judicial Form Retirement System (KJFRS). All three are completely separate pension systems with different boards, administrators, beneficiaries and investments.

What makes TRS unique?

TRS is Kentucky's largest single pension system and includes public school teachers and administrators. It's important because of the large number of participants and retirees, and the fact that teachers don't receive Social Security. As of June 30, 2018, TRS was 57.7% funded.

What makes KRS unique?

KRS is comprised of five individual pension funds all governed by the same board of directors.

- Kentucky Employees Retirement System (KERS) Non Hazardous Employees
- KERS Hazardous Employees
- County Employees Retirement System (CERS) Non Hazardous
- CERS Hazardous
- State Police Retirement System (SPRS)

What makes KJFRS unique?

KJFRS is by far the smallest and most well-funded of the commonwealth's pension systems. It provides retirement benefits for judges who serve on the Supreme, Appeals, Family and District courts.

However, it also allows sitting legislators to spike their pensions by taking another position in state government and then using that salary in the calculation of their legislation-pension benefits.

The practice is known as "reciprocity and was implemented in 2005 by the General Assembly. It continues to this day.

This policy has resulted in part-time legislators getting appointed to lucrative full-time positions within state government such as a judgeship or seat on the Public Service Commission – jobs which often pay much higher (often six-figure) salaries than they made in the General Assembly – and then using that salary to dramatically spike their retirement benefits for a lifetime.

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So what's the problem?

None of the state-managed pension funds have enough money in reserve to pay for the promised retirement benefits for state employees.

Just how bad is it?

The official deficit is approximately $40 billion; however, some believe the total is closer to $60 billion.

Contrast this with the Kentucky General Fund budget for the current fiscal year, which is less than $12 billion. It's clear that the problem is substantial.

What does a "defined benefit pension system" mean?

A "defined benefit" is a commitment to pay a fixed amount of money to a retiree on a monthly basis after he or she retires until death. TRS and KRS are defined benefit pension systems.

How is a healthy and successful defined benefit pension system supposed to work?

Actuaries determine the cost each year of the future retirement benefits for current state employees (this is called the Normal Cost).

Employees then contribute a percentage of their paycheck into the pension fund.

Employers (in this case the state of Kentucky and its taxpayers) then make a required contribution to the same pension fund.

The money in the pension fund is then invested and grows over time with an investment-return goal set by the board of each pension system, called the Assumed Rate of Return (AROR).

When an employee retires, they receive a monthly check for the rest of their life.

What's an actuary?

Actuaries are hired by the pension system itself to analyze the data related to the number of employees, growth in the amount of employee payroll, longevity of the lives of the retirees and numerous other important factors.

Problems can arise if actuaries use faulty data or intentionally manipulate information in order to provide the pension systems (their employers) with information that makes the health of the system look better than reality.

What's the Normal Cost?

The present-day cost of the predicted future retirement benefits that will eventually be paid to current state employees. This dollar amount should be paid in full into the pension system every year.

What's the Assumed Rate of Return (AROR)?

Each pension system sets a goal for their annual investment returns. This is a long-term goal as returns may fluctuate drastically from year to year. For a pension system to be healthy, the AROR must be achieved annually over the long term.

Severely underfunded pension systems typically have lower ARORs than fully funded systems. The investments within underfunded systems are more conservative as a prolonged economic downturn and losses in the stock market could make matters even worse.

Underfunded pension systems often are forced to sell investments earlier than preferred in order to pay benefits, which further restrains the potential for returns.

Why does a lower Assumed Rate of Return (AROR) matter?

Higher investment returns in pension funds mean more money will be available to pay retirement benefits.

Conversely, lower returns translate into fewer dollars available for benefits.

If the AROR is lowered but promised benefits don't change (as recently happened in 2018 at KRS), then employers will need to contribute more to the system.

When expectations are lowered for the future amount of money generated from investment gains, more funding is then required from the employer if benefits levels are to remain the same.

Isn't the problem in Kentucky all about the investment performance of the pension system investment portfolios?

The current AROR for TRS is 7.5% while the 30-year return for the investment portfolio was 8.39% as of June 30, 2018. Investment performance by the TRS managers has been excellent over the years and did not cause the underfunding problem.

The five plans within KRS have ARORs ranging from 5.25% to 6.25%. The lifetime return for the KRS portfolio is 9.14%.

While performance over the last decade has lagged due to a reliance on underperforming investments, investment returns are only a small contributor to the current deficit.

Wasn't this deficit caused by exorbitant investment fees paid to outside investment managers?

No. TRS has been managed very efficiently since inception and costs continue to be very low.

Fees paid by KRS did increase over the past decade due to an over-reliance on hedge funds. Total fees paid, however, make up only a very small portion of the entire unfunded liability. KRS has been actively lowering investment allocations to high-fee hedge funds in recent years.

What is meant by the phrase "just pay the ARC"?

The ARC means "Actuarial Required Contribution." It's the combination of the Normal Cost (cost of future benefits attributed to the current year of service) along with an additional payment meant to "catch up" the system to fully-funded status. The "catch-up" payment is typically amortized over 30 years.

ARC = Normal Cost + Catch-Up Payment

Why don't we just pay the ARC and reach fully funded status over time?

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Isn't this really just all about underfunding?

Underfunding has taken place in past years, especially during the Beshear and Fletcher administrations, which did contribute to the problem. However, underfunding is not *the primary cause* of the current deficit.

An inefficient and costly benefit structure along with retroactive benefit enhancements is primarily to blame.

What's a Retroactive Benefit Enhancement (RBE)?

State employees are promised a specific retirement benefit for each year of service. The cost is calculated and then contributions are required for the employee and the employer (normal cost). In Kentucky, it was common in the past for legislators to increase the promised retirement benefits for state workers and apply the increase retroactively back to the first day of employment. This resulted in the original required normal costs being too low as it underestimated the future costs to the state and taxpayers.

If legislators would have left past benefits untouched, the contributions would have been sufficient. By increasing benefits and applying them retroactively, however, the original amount contributed into the system was not nearly enough.

What's an example of a benefit enhancement?

Increasing the benefit factor applied to an employee's benefit calculation.

What's a benefit factor?

A benefit factor is used in the calculation to determine how much money an employee will receive annually as a retirement benefit. It's typically multiplied by the annual income amount of the employee's last year of service. That amount is then multiplied by how many years that same employee has worked.

For example, consider a state employee who worked 30 years, had an annual salary of $60,000 during their last year of employment and had earned a benefit factor of "2%".

- $60,000 (final salary) X 30 (years of service) X 2% (benefit factor) = $36,000 (annual pension retirement income)

Increasing the benefit factor even a small amount can result in much-larger incomes for retirees. For example, here's the same calculation with a benefit factor of 2.5% instead of 2%:

- $60,000 x 30 X 2.5% = $45,000

By increasing the benefit factor to 2.5% from 2%, the increase in pension payments to the retiree increases by a whopping 25%.

Increasing the benefit factor applied to the pension-income calculation was a frequent occurrence resulting in higher-than-anticipated benefit payments.

So what's the answer?

The commonwealth and taxpayers must honor the retirement benefits already earned by state employees. This will be a large sacrifice and will result in an outsized percentage of the state budget allocated to the ARC for quite some time. Fifteen cents of every $1 in the current General Fund Budget is dedicated to funding public pensions.

Increased funding is not the silver bullet, however. The future benefit structure and liabilities must be changed and streamlined in order to ensure that what led Kentucky to this point never happens again. Simply keeping the current employee benefit structure in place and only increasing payments to fund the ARC won't solve the problem.

What's the "inviolable contract"?

Each state has different rules pertaining to what can be changed regarding employee compensation and benefits.

In Kentucky, it's clear that benefits already earned are protected. What's unclear is whether or not future unearned benefits are protected from changes going forward.