John R. Farris
John R. Farris is founder and president of Commonwealth Economics, chairman of the board of trustees of Kentucky Retirement System, and founder and manager of the Commonwealth Infrastructure Fund and LandFund Partners. He was an economist at the Center for Economics Research at the Research Triangle Institute in North Carolina and was a senior economics consultant with the World Bank and International Finance Corp. From 2006-2007, Farris was secretary of the Kentucky Finance and Administration Cabinet. He is on the board of directors for GreenBrick Partners, Kentucky Technology Inc., Kentucky Employers' Mutual Insurance, and LandFund Partners LP. He is also senior investment advisor to the Centre College Endowment. He has a bachelor's in economics and philosophy from Centre College and a master's in economics and public policy from Princeton University. Farris was born and raised in Louisville and lives in Lexington with his wife, Rebecca, and their three daughters.

FINDING CREATIVE SOLUTIONS TO KENTUCKY'S FINANCIAL DILEMMAS

Working complex financial puzzles like TIFs and P3 funding is a passion for KRS Board Chair John Farris

BY MARK GREEN

Mark Green: How did you first become involved in financial jobs in public life? Is finance involving public systems and/or projects a personal passion?
John Farris: My first job out of graduate school at Princeton was at the World Bank. I followed a professor there to analyze the qualitative effectiveness of major infrastructure projects funded by the bank. I measured the impacts that large-scale infrastructure projects such as bridges, roads, dams can have on overall quality of life. Seeing the impact on people lives was inspirational. Almost immediately, I became passionate about understanding how to piece together the financing of large infrastructure and economic development projects to positively impact the quality of life in the country, state and local community. When I was asked by Gov. Ernie Fletcher to be finance and administration secretary, I carried this passion back to Kentucky and immediately went to work on infrastructure programs and projects for the commonwealth. I love figuring out a way to get involved in designing and financing better bridges, roads, schools, stadiums, dorms and many other projects. That is why I became interested in the state pension system; if our deficit keeps growing, not only we will have a tough time meeting our obligations to the people in the system, we will also crowd out all the necessary infrastructure spending for our state.

MG: If the proposals to shift from pensions to a defined-contribution system are enacted along with other changes to the systems, how long will it take to get the Kentucky pension system not necessarily fully funded but back onto a sound footing?
JF: That is a good question but let me start by saying that the only way to know the time frame for a solution is to not to make the problem worse than it is now. We are in a $60 billion hole. In 2007 that number was less than $10 billion. Each year we do nothing, the problem grows exponentially. The real key when you are in a big hole is to stop digging. If we switch to the proposed "defined contribution" plan and a "level dollar" payment plan, we have made the first real steps to a solution because the hole will not keep growing – with the proposed plan we are putting away the shovels. And under the proposed plan we are going to use level-dollar payment and pay our pension debt much like a mortgage over 30 years. That is a long-winded way to say, if we pass the proposed plan, we will immediately be on the right path and we will pay our accumulated liability off over 30 years.

MG: Are there parts of the pension reforms package you advocate most strongly, or think are the most crucial or beneficial?
JF: There are many good parts to the proposal in my opinion, but the two I think are most crucial are the "defined contribution" for new employees and the level-dollar plan. Let me talk just a minute about why using a "level dollar plan" instead of our current "percentage of payroll" payment plan is so very important.

When I became chair of KRS, I dug into the actuarial assumptions on payroll growth and realized they were ridiculously high. Why does that matter? When you use a "percentage of payroll" payment plan, the system makes funding payments based on a percentage of payroll, and your assumptions on future payroll really matter. For the last 10 years before I joined, the previous KRS board assumed payroll would grow at 4 percent a year compounded for the next 30 years, but payroll growth was actually close to zero or negative in most years. This is a big part of our current pension deficit problem. Imagine being allowed to pay less on your mortgage today because the lender believes that you will make more money in the future. Our pension funding system was similar to a lender setting your mortgage payment amount this year to be a lot less than in the future years because they think you will have 4 percent compounded income growth every year over the next 30 years. But then what if your income didn't grow and now isn't expected to grow in the future – you would be in serious trouble. That is exactly what has happened to the Kentucky pension systems. We expected payroll to grow 4 percent when it was obviously zero or negative. By switching to a "level dollar plan," expected payroll growth is not in the equation. We will be paying the same amount each year much like a regular mortgage. Incorrect and overly aggressive assumptions on payroll growth made by the prior pension boards are a major part of the reason we are $60 billion in the hole. I applaud the governor and legislature for proposing a plan that takes a lot of the guess work out of knowing what we really owe. We will pay our bill each year much like a taxpayer pays their mortgage each month – no funny math to get out of it.

MG: The proposed pension reform has multiple elements. Is it essential that all of them are part of a final bill passed by the General Assembly?
JF: I think the Bevin administration designed this proposed reform in its entirety so that the commonwealth can meet our future obligations to current employees and retirees. As chair of Ken-

tucky Retirement System, I have a fiduciary responsibility to both the pensioners and taxpayers to look at the proposed reforms from that lens. If you start picking away at it, I think we will have a harder time meeting our obligations.

MG: Part of the pension funding problem is that investment returns since the Great Recession have fallen short of expectations. Do you expect interest rates and investment returns to shift back toward the averages of the past 100 years anytime soon?
JF: Yes, that is also part of the problem. But we do not have the luxury or challenge at KRS to make our assumptions based on 100 years. It is hard enough figuring out what will happen in the next 30 years. In the history of mankind, investing in a stock market is a relatively new thing. We don't have thousands of years of history to look at trends like we do with the hard sciences, such as geology. We have 100 years or 150 years at best as our "investing" sample set, and in that sample set the best predictor for forward risk-adjusted returns is to look at the 30-year U.S. Treasury bond and forecast some risk-premium for risk assets for the next 30 years based on that indicator. The current 30-year T-bill sits around 3 percent, so based on that I am comfortable assuming 6 or 6.5 percent returns for a portfolio right now. If the 30-year was at historical norms of above 5 percent, I could get comfortable with historical norms on portfolio returns of 7.5 or 8 percent, but that is just not where we are right now.

MG: As chair of the KRS board, what involvement do you have in guiding investment of the system's billions of dollars in assets? Is there a rule of thumb for how asset investments are allotted, or does the distribution shift as market conditions change?
JF: We have a great investment committee. Gov. Bevin appointed four new members to the investment committee, including three chartered financial analysts (CFA) and one certified public accountant (CPA). These new members, combined, have 112 years of experience in investment management – an average of 28 years. The previous investment committee did not have one single investment professional. The first thing our new committee did was streamline overall investment policy into three major asset allocations: equities, 45 percent; debt, 30 percent; and diversified strategies, 25 percent. Then we terminated 27 underperforming or unnecessary hedge fund investments, which held over $800 million in assets; this will save over $11 million in fees.

We also are reducing the number of outside investment consultants, especially duplicative and redundant services, which includes letting go of one investment consultant charging $480,000 in retainer fees per year that was essentially a duplicative service. As a result of these changes and favorable market conditions, we returned 13.3 percent in fiscal year 2017 and for the first time in the last five years we actually beat our benchmark. In the 12 months that ended on June 30, 2017, or fiscal year 2017, we beat our benchmark by 17 basis points. We made $25 million more than we were supposed to make by our benchmark standards. That is good news for beneficiaries and taxpayers, and speaks to the hard work of our investment committee, which is made up of unpaid volunteers.

MG: Let's shift to TIFs. You helped draft Kentucky's 2007 update to the tax increment financing law, which in simple terms allows developers to use the growth in future tax revenues that projects create to pay off the public infrastructure portions of a development, such as roadway and utility elements. There was some learning curve, but how many TIFs are there now? What is the time frame for a TIF project?
JF: There are about two dozen TIFs either approved or in the process of approval in Kentucky. The state has five TIF programs, and depending on which TIF program is utilized they can last up to either 20 or 30 years. I would say the majority of TIFs in Kentucky are 20-year TIFs.

MG: Is there any such thing as a 'typical' TIF project? What are the most common types of developments that use TIF?
JF: No such thing as a typical TIF, but they are all characterized by needing to pay for the high cost of infrastructure. They use the future tax revenues created on the property by the project to pay for the high cost of infrastructure improvements that would have prevented the project from happening, and that is a great thing. We have one of the most innovative, well-designed TIF programs in the country, and it is only to pay for infrastructure that used to be paid for by state and local governments through handouts. Our program requires developers or cities to take the risk – not the state – and then only get paid back their infrastructure cost if the project is successful. This is a good thing. There are no "handouts" and the program has a ton of safeguards. Moreover, it is designed to be completely budget neutral. Finally, I would add that in the 15 years of TIF in the commonwealth, only $110 million has been paid out. That is less than $10 million per year and that is a very small amount – less than 0.01 percent of the state budget.

MG: Are Kentucky developers and public officials still learning how to utilize TIF and how to navigate the process?
JF: It is a good law, but because there are so many safeguards and checks and balances, using the TIF program is quite complicated. And not every development project would qualify. There generally has to be a very special circumstance. A Central Kentucky newspaper recently pointed to the Summit at Fritz Farm project in Lexington as a reason changes in the TIF program should be considered part of tax reform, and I think that is very ill-informed. The Summit project received TIF dollars to fix both upstream and downstream storm water and sewer issues created by other properties and required to be fixed by an EPA consent decree (formalized in 2011 by Lexington, state and federal officials, its hundreds of millions of dollars in improvements are to be completed by 2026). It was the private-sector developers, not the city or the state, that solved a major issue in that part of the county by spending millions of dollars to fix upstream and downstream water and sewer issues caused by other properties. They had to front the money then get paid back over 20 years. I think that is a great deal for Lexington and the state.

MG: Recently, at the request of six Kentucky banks, you launched the Commonwealth Infrastructure Fund. The banks are putting up $25 million each and will get involved in financing public-private partnership projects. How will it allow banks to participate in these deals?
JF: The Commonwealth Infrastructure Fund represents an unprecedented commitment by six banks that normally compete for business. Nowhere else in the country has a group of community banks combined their strengths to create a fund to invest in local infrastructure. Our fund will provide loans to development partners for projects like repairing and replacing aging roads and bridges, public buildings, updating local water and sewer systems, or improving infrastructure and services like student housing, treatment centers or charter schools. The pool of private dollars – zero taxpayer money – the fund has assembled provides a cost-effective alternative for private partners investing in public infrastructure. At the end of the day, it's the citizens of Kentucky who will benefit.

MG: How long might it take to use the $150 million committed to the fund? Might there be additional rounds of funding?
JF: Our goal is to lend the full $150 million in 24-36 months. The six initial banks have all asked for first right of

refusal in the next fund and since the announcement, multiple community banks from all across the state have contacted me asking to be part of the next infrastructure fund. Right now we are focused on making our first loan and first fund successful. I think this first one will be very successful, and there will be multiple funds in the future.

MG: Do you think that we are in the early stages of a broad shift to P3 funding of public projects?
JF: We are in very early innings. It was just last year, 2016, when Kentucky authorized the use of P3s with the signing of House Bill 309 into law. Kentucky's P3 authorization legislation allows both the state and local governments to use P3s to develop public infrastructure. It allows unsolicited P3 offers, which is very useful. P3s can provide significant value for taxpayers. By letting private partners contribute their capital and capabilities, local leaders can address important needs now, reduce the cost to citizens and improve efficiency.

MG: You previously held a job with the World Bank and International Finance Corp. Do you see any opportunities for Kentucky to get more involved in the world economy and attract foreign investment?
JF: I think the commonwealth has done a great job attracting foreign direct investment. To continue to attract additional foreign investment in the future, we have to continue to improve in three areas: educate our workforce with the proper skills, build better infrastructure, and implement a more competitive tax system.

MG: What do you mean by more competitive tax system?
JF: I am in favor of a broader-based sales tax with fewer exemptions. Also, we should work to lower the income tax. I think these two changes will be more efficient and will encourage economic growth. Just look at our neighbor to the south, Tennessee; they have given us the blueprint for economic growth.

MG: Is it appropriate for states such as Kentucky to have foreign entities participate in P3 projects? The Kentucky Wired gigabit network is such a project. Are there any categories of projects that should not include foreign participation?
JF: I was not involved in the Kentucky Wired project, but I am afraid from what I have seen so far it has the potential to give legitimate P3s a bad name. The Kentucky Wired project was well intentioned but it was given to a foreign company – Macquarie from Australia – and the deal was inked before the new P3 law passed. Unfortunately, it does not have any of the necessary safeguards to protect the taxpayers. The Bevin administration has done all it can to make the best of the situation but the die was cast before they took office and all the protections were given to the private foreign company. This is an example of a foreign company taking advantage of Kentucky taxpayers.

MG: How so? What is happening with this project, to which Macquarie had by initial appearances committed to invest more than $200 million to build a statewide gigabit network?
JF: The project is both over budget and behind schedule. If there were sufficient safeguards in place with the Kentucky Wired contract, the private vendor would be required to pay for these cost overruns and delays. The lack of available remedies in the contract ties our hands.

MG: You are the chief investment officer for Centre College. What does that involve? Does this mean you oversee investment of its endowment funds?
JF: I work to make sure the endowment is allocated correctly. The Centre endowment has had tremendous success the last few years and grown to over $300 million. Because I went to Centre on scholarship made possible by the endowment, I really enjoy trying to make the endowment successful so other students can have that opportunity. In my opinion, the Centre faculty, staff and alumni do everything the right way for current and future students. The focus is not just on merit-based aid but also on need-based aid, providing maximum aid to first-generation college students through generous gifts of alumni like David Grissom.

MG: Your company, Commonwealth Economics, specializes in structuring large project finances with complex financial frameworks. Do nearly all large projects today require complex financing both to distribute risk and pull together enough capital?
JF: Yes, my partners at Commonwealth are very good at figuring out financial puzzles. We love digging into big complicated deals with big impediments and challenges and figuring them out. We have been involved in setting up the financial structure in nearly every big project in Kentucky the last 10 years, including the Omni Hotel in Louisville, Summit in Lexington, the Louisville bridges, Owensboro's downtown redevelopment, the proposed new soccer stadiums in Louisville and Northern Kentucky, and the current Lexington Convention Center project, just to name a few. All of these projects take a healthy mix of private, local and state support as well as favorable reception in the debt and equity capital markets to make them happen. They are not easy, but they are very fun to put together.

MG: What type of large projects do you hope to see Kentucky public or private entities take on in the next five or 10 years?
JF: The go-to answer is usually the Brent Spence Bridge (I-75 crossing the Ohio River from Northern Kentucky to Cincinnati), but I am going to talk about a project that may be more important than the Brent Spence Bridge but is rarely mentioned. It is in the social infrastructure realm. Madison County is working on a P3 project to build a substance abuse treatment center instead of a new jail. This is incredibly important for our state. They have about 380 inmates in a 184-bed jail. But a new jail would cost $40-$50 million to build, while a new substance abuse treatment center should cost 50 percent of that amount to build and operate through a P3. Judge Taylor has political courage to try a new solution to fix and treat the problem that is leading to incarceration; this could be a game changer for our state. This is the type of innovation we need.

MG: There are so many economic/financial metrics to monitor – interest rates, GDP growth, employment rates, consumer spending, consumer confidence, etc. Is there a metric you watch more closely for guidance or consider more influential than others?
JF: If I could only look at one thing each morning it would be the 10-year U.S. Treasury yield. It is the most important metric to me and takes into account everything you just mentioned. It has been hovering between 1.5 and 3 percent for the better part of five years, and I would say it will either break above 3 percent or dip below 1.5 percent depending on federal tax reform, which has a 50/50 chance of happening at best. If tax reform happens or becomes more likely to happen, then I think it breaks above 3 percent and provides many years of economic growth and prosperity ahead for our country. If it dips below 1.5 percent from here, we are in trouble. I am optimistic. A lot hinges on federal tax reform. ■

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