EXECUTIVE SUMMARY

The Joint Committee on Pensions, Investments and Benefits studied the Kansas Public Employees Retirement System's long-term funding challenges during the 2009 Interim. The Joint Committee reviewed the December 31, 2008, Actuarial Valuation, a presentation by the System's consulting actuary, Milliman, Inc., and three presentations by KPERS' Executive Director describing KPERS' long-term funding challenges, along with a range of potential funding options to address them. Following its review, the Committee requested this report on KPERS' long-term funding status and funding alternatives, as well as historical information on KPERS' plan design, funding history, and steps previously taken by the Legislature to address KPERS' long-term funding concerns.

A Historical Perspective on Long-Term Funding

The Kansas Legislature created and established the terms of the Retirement System's defined benefit plan in the Kansas statutes. Since KPERS' inception in 1962, the Legislature has passed laws expanding and enhancing benefits for KPERS members. As a result, most of the basic plan design elements have been the subject of one or more enhancements at some point in KPERS' history.

The Legislature has adopted a range of approaches to valuing and funding these enhancements, including increases in employer contribution rates and changes in actuarial methodology; however, these enhancements have not always been adequately funded. The employee contribution rate has remained at 4%, even when such benefit enhancements were applied to previous service. A second tier of KPERS benefits with an employee contribution rate of 6% was added for individuals who became members on and after July 1, 2009.

In 1993, the Legislature enacted a law providing a collection of benefit enhancements that is of particular significance in understanding the development of the current KPERS' long-term funding shortfall. The benefit enhancements package included the following: changes to retirement eligibility allowing earlier retirement with full benefits, a higher benefit formula factor for both previous and future service, a one-time 15% ad hoc COLA for most retirees, and an increase in the retiree death benefit to $4,000.

The funding plan for the 1993 enhancements included an extension of the amortization period for KPERS' unfunded actuarial liability (UAL), changes in the actuarial funding method and the basis for computing amortization payments, plus a statutory cap on employer contribution rate increases of 0.1%. This funding plan lowered initial annual employer contributions, but significantly increased the UAL and built in higher costs over the course of the amortization period.

The funding plan for the benefit enhancement package, along with subsequent experience losses and other factors that adversely affected liabilities, contributed to the development of a long-term funding shortfall that became apparent during the market declines in 2001 and 2002. Actuarial projections from that period indicated that the KPERS retirement plan was not in actuarial balance.

Previous Legislative Actions to Address Long-Term Funding Problem

Following the 2001 actuarial valuation results, KPERS worked with the Legislature and the Governor to develop a comprehensive, long-term funding plan to address the shortfall and bring KPERS into actuarial balance. Key steps in the plan included phasing in increases in the statutory employer contribution caps from .2% per year to .6% per year, issuing $500 million in pension obligation bonds in 2004, making actuarial changes to generally accepted methods, and establishing a new plan design for KPERS members first employed on or after July 1, 2009.

These actions, along with strong investment returns in the FY 2004-2007 period, brought KPERS into actuarial balance and significantly improved the projected funding status through the December 31, 2007, Actuarial Valuation.

Assessment of Current Long-Term Funding Status

The extraordinary financial crisis of 2008 and early 2009 and its unprecedented investment market declines profoundly affected investors globally. The investment return for the S&P 500 was -26.2% during FY 2009, which is reflected in the System's return of -19.6% for the same period.

The investment losses had a substantial negative impact on the funding status of the Retirement System as a whole and reversed previous forward progress on long-term funding. As a result, KPERS' current funding structure is not projected to generate enough contributions to pay off the UAL in the amortization period ending in FY 2033. The funding problem facing KPERS does not constitute a crisis threatening its short-term viability. Instead, it is KPERS' ability to pay benefits over the long-term that is in jeopardy.

The nature and depth of the System's long-term funding challenges are illustrated by projections of three key measures of the System's long-term viability: (1) the unfunded actuarial liability (UAL), (2) the actuarially required contribution (ARC) rates, and (3) the funded ratios.

UAL. Looking at the System as a whole, the December 31, 2008, Actuarial Valuation reported a $2.7 billion or 49% increase in the System's UAL to $8.3 billion. On a current market value basis, the System's UAL is $10.3 billion, due to the $2.0 billion in investment losses from 2008 that will be averaged in over the next four years. Actual investment returns will determine how much of these deferred losses are offset in subsequent valuations. However, at current statutory rates, the UAL cannot be paid off within the current amortization period.

ARC Rates. As the remainder of the 2008 loss is averaged in over the next four years, the ARC rate will continue to grow substantially, except to the extent it is moderated by future investment gains. The School Group is out of actuarial balance, which means that the statutory rate does not match the ARC rate before the end of the amortization period in FY 2033, and the State Group's ARC rate of 14.41% at its ARC date (FY 2022) will be nearly double the statutory state/school rate paid by state agencies in FY 2010 (7.57%).

Funded Ratio. The funded ratio represents the proportion of the actuarial liability currently funded by the actuarial value of a plan's assets. This key measure illustrates the depth and severity of KPERS' long-term funding problem, and the potential consequences of its protracted vulnerability to future market downturns. For public plans, a funded ratio of 80% and rising is considered to indicate adequate funding. Funded ratios of 60% or below are considered to reflect severe underfunding requiring prompt remedial action.

The State's funded ratio has dropped to 72%. It is projected to fall to near 60% for six years and projected to reach 80% in FY 2027. The School Group's funded ratio immediately fell to 52%. It is projected to reach 41% in FY 2015 and remain at 41 to 43% for nine years. The funded ratio is not projected to reach 60% until FY 2031 and is projected to reach 80% in FY 2035. The Local Group's 2008 funded ratio dropped to 59%. It is projected to continue falling to 53% and is not projected to reach 80% until CY 2025.

Options to Address the Funding Shortfall

The Joint Committee has received projections related to a number of basic funding solution options and multiple variations that involve combinations of the following:

- increasing the statutory employer contribution rate cap
- increasing employee contribution rates
- adjusting the statutory multiplier for future service
- issuing bonds
- creating a new mandatory defined contribution plan for future employees

Analysis of these options illustrated trade-offs and limitations that will need to be weighed in determining actions to be taken to address KPERS' funding shortfall.

KPERS' ability to withstand future economic downturns has been compromised. With any of the funding options, substantial progress in the short to mid-term may be limited, and KPERS' funding status will remain tenuous for an extended period of time. All basic measures of KPERS' funding status clearly reflect this deterioration and indicate that the Plan is at risk over the long-term.

Efforts to address the long-term funding shortfall will need to be part of an ongoing process for a number of years. Legislative action is needed to begin that process, with additional employer contributions as a basic element of any funding option. Further steps, such as employee contribution increases and plan design changes also need to be considered in order to begin establishing a more sound foundation for KPERS' long-term financial health.