

**Report of the
Joint Committee on Pensions,
Investments, and Benefits
to the
2010 Kansas Legislature**

CHAIRPERSON: Representative Robert Olson

VICE-CHAIRPERSON: Senator Stephen Morris

OTHER MEMBERS Senators Jay Emler, Anthony Hensley, Laura Kelly, and Ruth Teichman; and Representatives Richard Carlson, Geraldine Flaharty, Terrie Huntington, Margaret Long, Sharon Schwartz, Dale Swenson, and Jeff Whitham

STUDY TOPICS

- The Committee is directed to monitor the operations of KPERS, to review public retirement benefits, and to consider Governor's nominees to the KPERS Board of Trustees, with a recommendation to the Senate regarding confirmation.

Joint Committee on Pensions, Investments, and Benefits

REPORT

CONCLUSIONS AND RECOMMENDATIONS

The Committee recommends to continue, during the 2010 Session, its review and discussions regarding long-term financing options. To that end, additional information and options were requested to be prepared for an anticipated meeting early in the 2010 Session, as early as the first week after the Legislature convenes on January 11, 2010.

Proposed Legislation: None.

BACKGROUND

The Joint Committee on Pensions, Investments, and Benefits is directed by KSA 46-2201 to:

- Monitor, review, and make recommendations relative to investment policies and objectives formulated by the Kansas Public Employees Retirement System (KPERs) Board of Trustees;
- Review and make recommendations related to KPERs benefits; and
- Consider and make recommendations on the confirmation of members nominated by the Governor (if any submitted during the interim period) to serve on the KPERs Board of Trustees.

Other interim topics for review may be assigned by committees of the Legislature, including the Legislative Coordinating Council (LCC).

The minutes and attachments for the 2009 Interim Committee meetings may be found in the Division of Legislative Administrative Services.

The Committee met September 2, November 17, and December 14, 2009.

COMMITTEE ACTIVITIES

The Committee is authorized by statute to set its own agenda and determine topics to study. For the 2009 Interim, the Committee primarily focused on long-term funding for KPERs since the LCC only approved three total meeting days. In addition, the Committee heard reports on KPERs investments and working after retirement.

Long-Term Funding. The KPERs Consulting Actuary, Milliman, Inc., provided the December 31, 2008, actuarial valuation report that estimates future benefit payments and calculates the different employer contribution rates. The Unfunded Actuarial Liability (UAL) increased by \$2.7 billion during calendar year 2008, but the total liability increased over \$4.0 billion if a market-based figure is used. The KPERs School Group is out of actuarial balance, and even with favorable investment experience and increased employer contributions mandated by current law, the group will not be fully funded by 2034 to pay all promised benefits. The funded

ratio for the KPERS School Group dropped from 63.0 percent to 52.0 percent on an actuarial basis of calculation, and the 0.6 percent increase in employer contribution, which is the current statutory contribution rate cap, will be insufficient to fully fund future retirement benefits, even if investments produce an average target return of 8.0 percent annually.

Projected employer contributions for all other KPERS groups (State, Local, Kansas Police and Firemen, and Judges) achieve an ARC date (Actuarial Required Contributions) prior to 2034 where assets equal liabilities. The State and Local groups reach an ARC date prior to the end of the amortization period.

Only the KPERS School Group does not reach an ARC date in the time period based on current law. The KPERS Consulting Actuary reports that the consequences of the KPERS School Group being out of actuarial balance with the statutory 0.6 percent annual increase in employer contributions would result in its UAL rising to \$10.3 billion in FY 2025 before it begins to decline. However, the funded ratio does not reach 60 percent until FY 2031, and it only reaches 80 percent in FY 2035. This 20 percent gap in the ability to pay promised the KPERS School Group's retirement benefits is the most acute KPERS long-term funding issue for the state.

By raising the employer contribution rate to a 1.0 percent annual increase as recommended by the Committee to the 2009 Legislature, (included in 2009 HB 2400 which is on House General Orders for consideration by the 2010 Legislature), the KPERS School Group would return to actuarial balance by FY 2023 and the employer contribution rate would rise to 19.76 percent. The UAL would increase to \$8.6 billion in FY 2020 before it begins to drop. The funded ratio would increase to 100 percent funding by FY 2035.

Because of concerns about the higher employer contribution rates and the ultimate cost to the State General Fund (SGF) if such higher rates were approved, the Committee asked to have additional models presented with other options for consideration in order to reduce the SGF impact. The FY 2011 employer contribution rate is 8.17 percent and the estimated cost for the KPERS State and School groups is \$374 million. Increasing the cap to 1.0 percent would cost an additional \$18.29 million in FY 2011. The SGF contributes approximately 85 percent of the employer contributions for the KPERS State and School groups which would be \$318 million in FY 2011, with an additional \$15.5 million associated with the proposed increase of 0.4 percent for employer contributions.

For the two other retirement plans, the KPERS Consulting Actuary also provided projections that the employer contribution rates for the Retirement System for Judges and the Kansas Police and Firemen's (KP&F) Retirement System could have rates increasing by FY 2015. to almost 35.0 percent for the Judges Group and almost 24.0 percent for the KP&F Group. For two of the KPERS groups, if no changes in the 0.6 percent cap were made, the employer contribution rate for the KPERS State Group could rise to over 12.0 percent by FY 2015, and the KPERS Local Group could rise to almost 12.0 percent by FY 2015. The impact of the investment losses will be recognized in future valuations due to the "smoothing" method used to shift the impact of investment losses and gains over a five-year period. The rise in employer contributions to meet the actuarial requirements for these plans is another KPERS long-term funding issue that will pressure state and local budgets with higher employer payments.

Additional information was received from KPERS about two groups for which the state and local units of government previously have contributed at the ARC following each actuarial valuation. The projections for the KP&F Retirement System and the Retirement System

for Judges indicate that employer contribution rates will rise dramatically as a result of the recent market losses. The KP&F employer rate will rise from 12.86 percent in the 2007 valuation to over 23.00 percent by the 2013 valuation. The Judges employer rate will rise from 19.49 percent in the 2007 valuation to over 33.00 percent by the 2013 valuation, according to the KPERS Consulting Actuary. The KPERS Board of Trustees adopted a recommendation at its November 20, 2009, meeting to suspend the application of its corridor in order to plan ahead for future rate increases and to allow possible relief from increases beyond 8.0 percent if future market gains are realized by 2013.

The KPERS Executive Director reviewed various long-term funding options designed to reduce the KPERS unfunded actuarial liability (UAL) while maintaining a defined contribution plan. Noting preliminary options considered at the meeting of September 2, 2009, he stated that the KPERS School Group is out of actuarial balance and, under the present statutory arrangement, and will never reach the ARC by 2034, the end of the 40-year amortization period.

At the November 17, 2009, meeting, the KPERS Executive Director explained nine options (A to G) to address the KPERS long-term funding issue. The different defined benefit options dealt with three components: adjusting the employer rate increase cap, adjusting the employee contribution rate, and creating a third tier of employees. The report outlined the effects of each option on employers, employees, and the State General Fund. The KPERS Executive Director stated that increases in employer contributions will take a number of years to have a positive effect, that changes in employee contributions are fraught with legal issues, and that a quick injection of money would require a large investment from pension obligation bonds.

Responding to questions, the KPERS Executive Director replied: (1) that recent court

decisions require any increase in an employee's contribution rate to include some offsetting increase in benefits; (2) that previous pension obligation bonds were helpful in bringing KPERS an infusion of cash that could be investment much sooner than increased employer contributions; and (3) that, on the contribution side, it would be difficult to separate the state pension system from the school pension system.

The KPERS Executive Director also outlined alternative defined contribution options for the Committee during the November 17, 2009, meeting. Explaining the difference between a defined benefit plan and a defined contribution plan, he said that the defined benefit plan specifies the benefits an employee will receive after retirement based on a formula. A defined contribution plan specifies the contribution rate that the employer and employee pay into the plan; most defined contribution plans are employee-directed and the retirement amount depends on the value of the account at retirement. He said the private sector trend for retirement plans tends toward defined contribution plans. In the public sector, Michigan and Alaska have mandatory defined contribution plans, six other states have optional defined-contribution plans, and seven states have hybrid plans. He stated that the Kansas Board of Regents has a mandatory defined contribution plan, that some local governmental entities and school districts have voluntary defined contribution plans, and that some state employees participate in a state-level deferred compensation plan with no employer matching contribution. A limited group of state officials may participate in a statutory defined contribution plan where the state pays 8.0 percent and nothing is required by the employee.

The KPERS Executive Director compared the defined benefit and defined contribution plans as to various risks: investment, liability, longevity, inflation, asset allocation, and investment management. He noted that if KPERS were to move to a defined contribution plan, the new plan would not eliminate the KPERS current UAL, and

the promised retirement benefits would have to be paid. He reviewed three options for a defined contribution plan and listed the consequences on the current UAL, the percentage of funding under each option, and the costs to the state. He offered three scenarios to illustrate retirement adequacy under different options. Details for the various alternatives presented at the November 17, 2009 meeting may be found in the attachments on file in the Division of Legislative Administrative Services.

At the December 14, 2009, meeting, additional materials were provided to further develop alternatives for consideration. Two alternatives using pension obligation bonds were reviewed by KPERS staff and a representative from the Kansas Development Finance Authority (K DFA) which issued the previous KPERS pension obligation bonds in 2004. That issue had totaled \$500 million, resulting in a net KPERS' investment of \$440 million. The principal and interest payments through FY 2034 include \$36.1 million annual paid from the State General Fund.

The two prospective bond issues included options for \$660 million with a net of \$590 million to KPERS, and for \$1.2 billion with a net of \$1.055 billion to KPERS. The K DFA representative noted the state's current bond rating and the potential impact on future ratings if pension obligation bonds were issued. K DFA concluded that there was a potential negative impact of additional pension obligation bonds. Details of the two bond options may be found in the attachments on file in the Division of Legislature Administrative Services.

Other options were presented at the December 14, 2009, meeting. These other options were variations on alternative plans previously reviewed by the Committee. After reviewing the various options, it became clear that providing additional funding quickly and in larger amounts would result in the greatest reductions in the ARC rates and UAL; a smaller

decline in the funded ratios through FY 2014; and lower total employer contributions through the end of the amortization period in FY 2034.

Investment Operations. The KPERS Chief Investment Officer provided periodic reports about the improving financial performance of the investment portfolio during 2009. Total assets at market value rose to almost \$11.4 billion on September 30, 2009, from a low point on December 31, 2008, of under \$9.9 billion. KPERS contracts with a number of outside investment managers to handle its portfolio, paying in FY 2009 a total of \$24.3 million for such services. Nine contractors provide services for domestic equity investments, seven firms direct international equity investments, two firms provide global equity investment management, five contractors assist with fixed income management, one provider is contracted for real return investments, three firms direct real estate investments, and one firm provides cash management services.

During the past year, several changes were made in the portfolio managers. Two international equity managers were terminated, and five new management firms were hired. The real return investments were outsourced to a new contractor, and two new, additional managers were hired for the fixed income portfolio. A portion of the real estimate investments were outsourced to a new contractor, and a total of three new real estate managers were hired.

The KPERS investment process was explained in relation to selecting investment managers through competitive bids and the costs of using outside managers to handle the portfolio's investments. Last year for FY 2009 ending June 30, for instance, KPERS paid over \$24 million for investment-related services. All service contracts were acquired through competitive bids and poorly performing managers are replaced, if warranted.

Working after Retirement. The KPERS Executive Director provided a status report on issues regarding working after retirement, noting that Kansas statutes and IRS regulations impinge on an employee's choices in working for a KPERS participating employer after retirement. Reviewing new 2009 recent legislation, he said that 2009 Senate Substitute for HB 2072 eliminated for three years the \$20,000 earnings limitation for retirees who return to work for the same school district from which they retired after being off the payroll for at least 60 days. The same bill also included a number of other provisions that addressed licensed school professionals who return to work after retirement, including a requirement that the employing school district or private contractor pay an actuarial assessment to KPERS that is determined each year to partially cover the lost income when a new KPERS contributing teacher or administrator is not hired.

As of December 31, 2008, there were 2,672 KPERS retirees who had returned to work. For those rehired by a KPERS participating employer, 1,351 were rehired by the same employer (usually a school district) and 1,321 were hired by a different KPERS participating employer, typically a school district. In 34 cases, private consulting firms assigned KPERS retirees to school districts as contract employees. This year's data are being collected with the start of the new school term and a comprehensive picture should emerge by the start of the 2010 Session that describes the effects of the new law on working after retirement.

The Deputy Commissioner, Kansas Department of Education, noted that the new 2009 law is being well received by school districts wanting to hire back recent retirees without using a contractor to obtain such services now that the \$20,000 cap is suspended for three years. He commented that the downturn in the economy has increased registrations for the free-lunch program and that student enrollment has increased even in rural areas, the latter

which normally shows a decline. He replied that continuing the exemption of substitute teachers from 2009 Senate Substitute for HB 2072 has not resulted in abuses since substitute teachers are paid about half what a rehired or a contract teacher receives. He commented that the economic downturn has resulted in fewer eligible teachers retiring this year.

Change in Actuarial Assumptions. The KPERS Board of Trustees suspended for one-year one part of the approved methodology used in performing actuarial valuations for the KP&F Retirement System and the Retirement System for Judges. The information was presented to the Committee at its last meeting. The KPERS Consulting Actuary told the Committee that upon recommendation to the KPERS Board of Trustees, the one-year suspension of the "corridor" of 80 to 120 percent of the market value used in the determination of employer contribution rates in the actuarial valuation was approved. Due to the large market losses in 2008, the application of the "corridor" methodology resulted in unusually large increases in employer rates and would have had an adverse effect of state and local budgets. If the "corridor" method had been applied, the KP&F employer contribution rate would have increased 5.02 percent in one year, and the Judges employer contribution rate would have increased 6.89 percent in one year.

The KPERS Executive Director explained that the issue would be studied because of the long-term implications for changing an approved methodology. The Board's action was taken as an extreme measure to mediate budget impacts, and if the "corridor" continues to create volatility in the employer contribution rates when "smoothing" is most needed to even out large swings in payments due to unusual market losses, then a permanent change will be made in the actuarial methodology.

CONCLUSIONS AND RECOMMENDATIONS

The Committee took no final action and did not adopt any recommendations that address long-term funding. Instead, the Committee plans to continue its review and discussions regarding long-term financing options during the 2010 Session. To that end, additional information and options were requested to be prepared for an anticipated meeting early in the 2010 Session, possibly the first week after the Legislature convenes on January 11, 2010. No action was taken regarding the other topics, including investment operations, working after retirement and change in actuarial assumptions.