Kansas Public Employees Retirement System
Long-Term Funding Plan
Board of Trustees' Recommendations

Since its inception in 1962, the Kansas Public Employees Retirement System has provided retirement and related benefits for thousands of Kansas public employees. Today, the System serves nearly 250,000 members and 1,450 participating employers. In recent years, the Board of Trustees, in conjunction with the Legislature and the Governor, has worked toward solving the System's long-term funding issues. The purpose of this report is to provide recommendations on the next steps for improving the long-term health of the System and assuring its continued ability to provide retirement benefits for state and local public servants across Kansas.

Background and Funding History

The Retirement System's primary funding objective has always been to accumulate sufficient assets during members' working careers to pay all promised benefits when members retire. The current funding plan was developed as part of the 1993 benefit enhancement package that included a 40-year plan to finance the enhancements. The funding plan incorporated several actuarial changes along with gradual increases in employer contribution rates. These incremental increases in contributions were designed to cause statutory employer contribution rates to eventually converge with the recommended actuarial rates required to fund the benefit levels.

During the latter half of the 1990s, higher than expected investment returns masked the impact of not contributing at the actuarially required rates. When the investment markets delivered lower than expected returns in 2001, 2002 and 2003, in conjunction with a restatement of a portion of the System's liabilities, it became apparent that the present pace of contributions would be insufficient. In fiscal year 2006, State/School contributions are projected to be 58 percent of the required rate while local contributions will be 63 percent of the required rate. At this pace, the State/School group's funded ratio (level of assets to aggregate liabilities) is projected to decline to less than 60 percent by 2012. Absent an increase in additional contributions, projections were for annual increases in future contributions with the convergence of the statutory rate and the recommended actuarial rate never occurring.

The Retirement System's Board of Trustees, staff and actuary have worked closely with the Joint Committee on Pensions, Investments and Benefits to develop an understanding of this complex and dynamic issue. Over the past two years, the Joint Committee has reviewed two detailed reports on the origin, nature and implications of the funding issue, along with hundreds of pages of analysis and testimony on methods of addressing future funding. In response, during the 2003 Session, the Legislature passed House Bill 2014 which increased the annual cap on State/School employer contribution rates. These increases, along with above average investment returns thus far in calendar year 2003, will help move employer rates toward actuarially sound levels and provide a significant step towards restoring the State/School group's financial health.

Although progress has been made, significant challenges remain. Absent additional action, the statutory employer contribution rates are not projected to converge with actuarially required rates for 25 to 30 years. Consequently, the System's consulting actuary predicts continued financial deterioration unless additional steps are taken. The Board is aware of State and local budgetary pressures and recognizes the scarcity of current resources available to provide commitments for additional funding. Having acknowledged these challenges, the Trustees will continue to work on behalf of the System's members in fulfilling their legal and fiduciary duty to advocate policies that provide for the health and stability of the System. With these goals in mind, the Board of Trustees respectfully recommends consideration of the following actions.

Recommendations

1. Actuarial Issues

Providing the Board with the ability to select the actuarial cost method would allow the System to take a long-term view and distribute future costs equitably over future payrolls. The current actuarial cost method has the potential to provide for steadily increasing contribution rates in certain situations, thereby reducing the System's flexibility in plan design in the future. The choice of which actuarial cost method best meets the needs of the System is a highly technical issue for which the Board is best equipped due to their background and continuing involvement with actuarial issues. In a similar fashion, providing the Board with the ability to define the amortization period would allow for optimal implementation of a future reamortization, fully reflecting the then current circumstances of the System**.**

Recommendation: The 2004 Legislature should amend current statutes to provide the Retirement System's Board of Trustees the authority for all three retirement plans (KPERS, KP&F, and Judges) to:

a. adopt the actuarial cost method for calculating liabilities; and
b. determine the amortization method and period for unfunded actuarial liabilities.

Upon implementation of these statutory changes, the Board of Trustees will adopt the following actuarial changes as recommended by its actuary:

a. the Entry Age Normal actuarial cost method for the KPERS, KP&F, and Judges retirement plans;
b. a five-year asset smoothing method for asset valuation; and
c. a plan to reamortize the KPERS State/School group's unfunded actuarial liability at some optimal date in the future, pending actual conditions at that time.

2. Employer Contribution Increases

The best measure of the overall health of the Retirement System is the funded ratio (the ratio of the actuarial value of assets to the actuarial liability). Without additional funding, projections indicate the System's financial condition, as measured by its funded ratio, will continue to deteriorate. The best means by which the funded ratio can be raised is through increased contributions.

Local contribution increases that coincide with the State/School increases provided in HB 2014 would significantly improve funding for that group. State/School contributions are already scheduled to increase beginning in fiscal year 2006 but need to be raised beyond levels presently specified in State statutes. Acknowledging that the HB 2014 increases are the first step in improving the Retirement System's long-term health, the Board encourages ongoing analysis and consideration of further contribution increases for the State/School group.

> ***Recommendation:*** The 2004 Legislature should amend current statutes to increase the contribution cap for KPERS local group employers to at least the HB 2014 levels of 0.4 percent for calendar 2006, 0.5 percent for 2007, and 0.6 percent for 2008 and beyond with an ultimate goal of contributing at actuarially recommended levels.

> ***Recommendation:*** The Legislature and Governor should continue to consider alternatives for increasing future contributions for the KPERS State/School group sufficient to reach and maintain a rate equal to recommended actuarial levels. The Board further recommends that any implemented funding alternatives be designed to maintain the State/School group's funded ratio at or above a minimum level of 60 percent with an ultimate goal of full funding.

3. Pension Obligation Bonds

HB 2014 provides for the issuance of up to $500 million in pension obligation bonds for the purpose of funding a portion of the State/School group's unfunded actuarial liability. The ability to securitize future contributions at a cost approximating 6 percent through the issuance of bonds compared with the 8 percent actuarial assumption provides projected present value savings to the State of approximately $100 million in future contributions. The risks of issuing pension obligation bonds include the conversion of a more flexible contribution stream into a more rigid debt service schedule, the potential impact on the State's debt capacity, and the failure to realize the assumed rate of return on the additional deposit. With regard to the long-term earnings assumption, the Trustees continue to believe that the current assumed 8 percent rate of return is a valid long-term expectation for investment returns.

Given that the best measure of the System's overall health is its funded ratio, the objective should be to improve the funded ratio. While the best means to improve funding is increased contributions, additional monies, from whatever source, strengthen the financial health of the Retirement System. Funding projections clearly demonstrate that the System's funded ratios improve with the issuance of pension obligation bonds.

> ***Recommendation:*** Proceeds from the issuance of pension obligation bonds are therefore a suitable means of partially addressing the long-term funding concerns, particularly if the bond issue is amortized in addition to employer contributions. The System should

continue to provide analytical support and counsel regarding the Joint Committee's consideration of pension obligation bond alternatives.

4. Plan Design Changes

Significant design changes, particularly those that may have an ancillary impact on the ability of the State to continue to attract and retain quality employees, should be thoroughly considered from a cost and benefit perspective. The System is prepared and willing to assist with this analysis.

> ***Recommendation:*** The legal, financial, and functional impacts of plan design changes should be studied extensively and analyzed carefully before considering alternatives that incorporate such changes.

5. Continued Evaluation and Reporting

Ensuring the Retirement System's long-term financial health will require a multi-year, collaborative approach involving State and local officials as well as the System's Board and staff. The Board of Trustees and staff are committed to making every effort to support the chosen course of action through diligent management of the System's assets and ongoing communications with the Legislature and the Governor.

> ***Recommendation:*** The Retirement System's Board of Trustees should prepare and communicate to the Joint Committee and the Governor, on an annual basis, updated information on the System's current and projected funded ratios, level of contribution adequacy, and recommendations for improving or sustaining the System's financial health.

Conclusion

If adopted, the Board of Trustees believes these recommendations will continue to advance the status of the System, its current funding and future financial health. The Board of Trustees appreciates the opportunity to provide input and recommendations and remains committed to working with the Legislature and the Governor to develop a responsible funding plan that will ensure the Retirement System's long-term financial stability.