MINUTES

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM STUDY COMMISSION

July 22, 2011
Room 346-S—Statehouse

Members Present

Senator Jeff King, Co-chairperson
Representative Mitch Holmes, Co-chairperson
Senator Laura Kelly
Representative Steven Johnson
Representative Ed Trimmer
William Buchanan
Edward Condon
Christopher Long
Rebecca Proctor
Michael Ryan
Paul Seyferth
Richard Stumpf
Brian Winter

Ex Officio Members Present

Glenn Deck, Executive Director, Kansas Public Employees Retirement System
Mary Torrence, Revisor of Statutes
Alan Conroy, Director, Kansas Legislative Research Department

Ex Officio Member Absent

Steve Anderson, Director, Division of the Budget

Staff Present

Julian Efird, Kansas Legislative Research Department
Michael Steiner, Kansas Legislative Research Department
J.G. Scott, Kansas Legislative Research Department
Gordon Self, Office of the Revisor of Statutes
David Wiese, Office of the Revisor of Statutes
Daniel Yoza, Office of the Revisor of Statutes
Connie Burns, Commission Assistant

Conferees

Glenn Deck, Executive Director, Kansas Public Employees Retirement System
Patrice A. Beckham, Cavanaugh Macdonald Consulting, LLC

Organizational Matters

The meeting was convened by Senator Jeff King. Senator King chaired the Senate Select Committee on KPERS this past Legislative Session, and served as the lead Senate member for the conference committee on Senate Sub. for HB 2194 that created the Commission.

Representative Mitch Holmes introduced himself. Representative Holmes chaired the House Committee on Pensions and Benefits this past Legislative Session, and served as the Chairperson for the conference committee on Senate Sub. for HB 2194 that created the Commission.

Jeff Russell, Director, Legislative Administrative Services, briefed the Commission members on the compensation for serving and payment of expenses for the legislative and non-legislative members.

Senator King summarized the Commission's charge in Senate Sub. for HB 2194.

Senate President Steve Morris welcomed the Commissioners. He presented a brief legislative history on the Kansas Public Employees Retirement System (KPERS) and various legislative attempts to fix its long-term funding.

Members of the Commission introduced themselves.

Gordon Self, Office of the Revisor of Statutes, presented a brief summary of Senate Sub. for HB 2194 (Attachment 1). The bill provides for:

- The establishment of the KPERS Study Commission;
- An appropriation for KPERS expenditures not to exceed $60,000 from its fee funds for actuarial services;
- An increase in employer contributions;
- For the different tiers of employees, an election related to the contribution rate, retirement benefit multiplier, and COLA for tier 2 members. This election provision must be approved by the IRS; and
- The disposition of proceeds from the sale of real estate by state agencies and its deposit to the KPERS fund.

Mr. Self described the KPERS Study Commission, membership, duties, and the certification of triggers during the 2012 Session as contained in new Section 10 of Senate Sub. for HB 2194.

Election of Officers

Representative Steven Johnson moved for Senator Jeff King and Representative Mitch Holmes to be co-chairpersons of the Commission. Senator Laura Kelly seconded the motion. The motion carried.

Overview of Current KPERS Status

Glenn Deck, Executive Director, KPERS, provided background information for the Commission (Attachment 2). The KPERS mission is to provide retirement, disability and survivor benefits to members and their beneficiaries. There are three statewide, defined benefit plans for public employees:

- Kansas Public Employees Retirement System;
- Kansas Police and Firemen's Retirement System; and
- Kansas Retirement System for Judges.

KPERS participating employers include state and local governmental employers, such as:

- The State of Kansas;
- 293 school districts;
- 105 counties;
- 474 cities and townships; and
- Numerous other entities, including libraries, hospitals, community colleges, and conservation districts.

The KPERS plans and programs are governed by a nine-member Board of Trustees and have 85 staff members. The membership serves 279,000 members, with the State of Kansas the largest participating employer, and more than half of active members employed by school districts. Total membership is made up of 158,000 active, 77,000 retired, and 44,000 inactive members. The active membership is distributed as follows:

- School districts and colleges—84,000;
- Counties and municipalities—35,000;
- State of Kansas—26,000;
- Other entities—6,000;

- Kansas Police and Firemen (KP&F)—7,100; and

- Judges—300.

The Kansas Legislature enacts statutes defining benefits and how funding is to be derived. The benefits are contingent upon membership eligibility, with both employee and employer contributions required of participants. Investments are used to provide part of the funding stream for benefit payments, along with contributions.

The Defined Benefit Formula is:

Final average salary X years of service X multiplier = Annual Benefits.

Benefits are a fixed monthly amount, paid for the remainder of the retiree's life (with beneficiary options). The average monthly benefit for KPERS retires as of December 31, 2010, was $1,024.

The Retirement Funding Formula is:

Contributions + Investments – Expenses = Benefits.

Contributions

Under current law, the KPERS' total contributions in FY 2011 were $855 million. Members are required to make contributions according to which tier they belong:

- Tier 1 = 4.0 percent; or

- Tier 2 = 6.0 percent.

Employer contributions are preceded by an annual actuarial valuation to determine the actuarial required contribution (ARC), but a statutory cap on the annual rate of increase is set at 0.6 percent. The State of Kansas pays employer contributions for both the state group and school group of KPERS, with the two groups treated as the state and school group for certain actuarial calculation, and as separate groups for other calculations.

Investments

Contributions are invested in a diversified portfolio that are hoped to grow over time. Investment earnings make up the largest portion for the payment of benefits. The KPERS Board of Trustees adopted and maintains a long-term investment return assumption of 8.0 percent.

A Commissioner asked how long the assumed returns had been set at 8.0 percent, and how the 8.0 percent compared to other states. Mr. Deck responded that the return has remained at 8.0 since 1986, and that 8.0 percent is the predominate assumed rate of return among the other state retirement systems. He noted that the KPERS Board has looked at this assumption, and has decided to retain the 8.0 percent actuarial return assumption, and then revisit the issue again next year.

Expenses

Investment management fees for FY 2011 were 0.30 percent of total assets, and benefit administration fees were 0.07 percent of total assets, Mr. Deck noted.

Benefits

The KPERS FY 2011 benefit payments exceeded $1.26 billion, with the benefits being paid from the KPERS Retirement Trust Fund, which is required by the IRS to be used for the exclusive benefit of members. Approximately 85.0 percent to 90.0 percent of benefit payments are to persons living in Kansas.

Assets

KPERS manages the investment of $13.3 billion of trust fund assets that are invested in the U.S. and international markets, with the assistance of investment management firms under contract to provide such services.

Investment Returns

The past ten years had four of the lowest fiscal year total returns (since 1976) for the Retirement System, but the 20-year average annual return remained above the 8.0 percent actuarial assumption. The FY 2011 total return through May 31 was 23.5 percent, and the preliminary estimate of total return in FY 2011 is 22.2 percent.

Funded Status

The KPERS Consulting Actuary conducts an annual actuarial valuation of the KPERS plans. The valuation is a snapshot view of the KPERS' financial status at one point in time. The key measurements of a pension plan's funded status are:

- Unfunded Actuarial Liability (UAL)—the UAL is the accrued actuarial liability for benefits minus the actuarial value of assets.
  - The KPERS UAL increased by $3 billion in last five years to current $8.3 billion.
- Funded Ratio—the ratio of the actuarial value of assets to the accrued actuarial liabilities.
  - A funded ratio of 80.0 percent or higher generally is considered adequate. A funded ratio of 60.0 percent or lower is considered at significant risk and requires action to address the funding issue.
  - KPERS' overall funded ratio hovered around 60.0 percent the last three years, and school group has been below 60.0 percent for several years.
- Actuarial Required Contribution (ARC)—The required employer payments made at the ARC are necessary to prefund benefits and pay-off the UAL over the remaining amortization period.
  - State and local governments have not contributed at ARC since 1994.

- For FY 2012, the state and school group statutory contribution rate will pay only 62.0 percent of the ARC.

Historical Perspective on Long-Term Funding

Over KPERS 49-year history, the Legislature enacted various benefit enhancements for active members and retirees. A significant benefit enhancement package passed by the 1993 Legislature that:

- Established unreduced retirement eligibility under the “85-point rule” (when the sum of a member’s age and years of service credit equals 85); at age 62 with 10 years of service; or age 65 with one year of service.

- Increased the retirement benefit formula from 1.4 percent to 1.75 percent for both prior and future service.

- Provided an average of a 15.0 percent cost-of-living increase for retirees and beneficiaries.

To fund these enhancements, employer contributions were capped in the initial years to phase-in the increased payments, thus shifting the cost of enhancements into the future. The enhancements and phase-in of the ARC, along with subsequent investment losses and other experience factors adversely affected liabilities, and contributed to long-term funding issues that emerged in 2001. The actuarial projections indicated that the KPERS retirement plan was not in actuarial balance.

Previous Actions to Address Funding Status

Following the 2001 actuarial valuation results, KPERS worked with the Legislature to develop a comprehensive, long-term funding plan to address the shortfall and bring the plans into actuarial balance. In 2003, legislation raised statutory caps on employer contribution rate increases from 0.2 percent annually to 0.4 percent in FY 2006, 0.5 percent in FY 2007; and 0.6 percent in FY 2008 and subsequent years.

The State of Kansas issued $500 million in pension obligation bonds in 2004. The debt service payment on these 30-year bonds is paid from the State General Fund, amounting to $36 million annually. The 2007 legislation established a new plan design for employees hired on or after July 1, 2009, which modified retirement eligibility for unreduced benefits and increased employee contributions to pay for a new automatic cost-of-living adjustment of Tier 2 members.

These actions, along with strong investment returns in the 2004-2007 periods, significantly improved the projected long-term funding status.

Impact of 2008 Downturn on Funded Status

The unprecedented market declines in 2008 had a substantial negative impact on the long-term funding status, reversing forward progress of the preceding years. The actuarial valuation report of December 31, 2008, reflected a 12 percent decline in the actuarially funded ration to 59.0 percent, and a $2.7 billion increase in the unfunded actuarial liability (UAL) to $8.3 billion.

The school group was out of actuarial balance, which meant, given the existing funding structure, there would not have been enough assets to provide all the benefits already earned by KPERS members by the end of the amortization period in 2033.

2011 Legislative Response

The 2011 State of the State address by Governor Brownback included KPERS as one of three key priorities.

Both the Senate and House leadership created new legislative committees, the Senate Select Committee on KPERS and the House Committee on Pensions and Benefits, to address the unfunded liability and ensure the integrity and soundness of KPERS. These legislative committees considered a range of options and held hearings on several bills related to long-term funding and other modifications to the existing plans. Each Chamber passed different bills. A conference committee on Senate Sub. for HB 2194 reached an agreement on legislation and the Conference Committee Report on Senate Sub. for HB 2194 was approved by both chambers. The bill was signed by the Governor.

Senate Sub. HB 2194 Overview

David Wiese, Office of the Revisor of Statutes, presented an overview of Senate Sub. for HB 2194 (Attachment 1). The bill provided for delayed implementation of several changes that would become effective only if the 2012 Legislature acts on legislation recommended by the KPERS Study Commission.

The bill also contained a provision that, subject to IRS approval, would allow for a one time election for both Tier 1 and Tier 2 members. Tier 1 members may elect either to increase their contributions to 5.0 percent in 2014 and to 6.0 percent in 2015 in order to have their multiplier increased from 1.75 percent to 1.8 percent for service earned on and after January 1, 2014, or they may choose to continue to contribute 4.0 percent and have their multiplier decrease to 1.4 percent for service on and after January 1, 2014. Tier 1 members who fail to make an election shall contribute 6.0 percent and would receive the increased 1.85 percent multiplier.

Tier 2 members either may elect to keep their multiplier at the current 1.75 percent and forgo any COLA, or they may elect to take a reduced 1.4 percent multiplier for service earned on and after January 1, 2014, while maintaining their COLA. Tier 2 members who fail to make an election will have their contribution rate remain at 6.0 percent with the 1.75 percent multiplier and no COLA.

If the IRS does not grant approval of an election, Tier 1 members shall have their employee contribution rate increased to 6.0 percent and receive a 1.85 percent multiplier, and Tier 2 members will no longer be eligible for a COLA and will continue to have a 1.75 percent multiplier.

Key 2010 Valuation Results

Mr. Deck returned to summarize the December 31, 2010 actuarial valuation report that showed an increase in the unfunded actuarial liability (UAL) of $590 million to $8.3 billion and a decrease in the funded ratio from 64.0 percent to 62.0 percent. The UAL will continue to increase in future years and the funded ratio will continue to decrease for several more years. Key valuation highlights included the following:

- School group with 55.0 percent funded ratio is cause for concern.

- Without Senate Sub. for HB 2194, the state and school group is projected to reach ARC in FY 2031 at an employer contribution rate of greater than 20.0 percent.

- With Senate Sub. for HB 2194, the state and school group is projected to reach ARC in FY 2018 at 14.46 percent for the employer contribution rate.

KPERS Board Actions

The KPERS Board submitted a request in June 2011 to the IRS for a letter ruling on offering KPERS members an election regarding benefit and contribution choices pursuant to Senate Sub. for HB 2194.

The KPERS Actuary recently completed two triennial studies, an asset liability study and an experience study. The asset-liability study helps to develop an appropriate asset mix and to guide investments. The experience study evaluates KPERS actual experience as compared to its demographic and economic assumptions. The Board establishes new or revised actuarial assumptions using the findings of experience study. This year the Board adopted a small number of technical changes to its demographic assumptions.

Mr. Deck stated that despite strong investment returns the past two years, the latest actuarial valuation showed a modest actuarial funding decrease and that the long-term funding shortfall will continue to grow. The additional employer and employee contributions and plan design changes included in Senate Sub. for HB 2194 would be a meaningful step, improving the long-term funding outlook and allowing the actuarially required contribution levels to be reached sooner and at lower levels than under current law. The impact of the additional employer and employee contributions in improving the funded ratio and the funded status will be limited in the next ten years. Consequently, the plans are vulnerable to future economic downturns that cause investment returns to decline.

Summary of Actuarial Valuation

Patrice A. Beckham, Cavanaugh Macdonald Consulting, LLC, the KPERS Consulting Actuary, presented the December 31, 2010 actuarial valuation results (Attachment 3).

The purpose of an actuarial valuation is the measurement of assets and liabilities at a certain point in time. The actuarial valuation is used to calculate employer contribution rates in FY 2014 all three plans and for CY 2013 that local units will pay under two plans.

Since this was the first actuarial valuation performed with software from Cavanaugh Macdonald, the previous report using the Milliman software was replicated with the same assumptions and data. There were differences in the key valuation results for the December 31, 2009 reports using the different software. The calculation of actuarial liability differed by $26 million and there was variance in the normal cost rates, both of which were described as typical in replication valuations.

For December 31, 2010 the actuarial valuation found that the unfunded actuarial liability for all plans increased from $7.677 billion to $8.264 billion, with an addition $672 million of net deferred investment loss experience that has not yet been recognized due to smoothing. The actuarial funded ratio for all plans decreased from 64 percent to 62 percent and using the market value of assets, the funded ratio increased from 56 percent to 59 percent. An additional $320 million of increased actuarial liability was attributed to not paying the actuarial required contributions (ARC). The cumulative total for not paying ARC since 1994 was estimated at $2.806 billion due to under-contributing by participating employers.

Discussion of Future Meetings and Locations

Co-chairperson King called for a discussion on timeline, future meetings and locations. A report is required to be submitted to the Legislature by January 6, 2012. The consensus was to try having two-day meetings in August, September, October and November, and a one day meeting in December. The Co-chairpersons indicated a preference to hold meetings in difference locations within the state. To request permission to travel, a letter must be submitted to the LCC in order to gain approval for reimbursement of costs. Discussion centered on the possibility of using the Regents' distance learning centers and using technology to take the meetings to remote locations.

Senator Kelly moved for staff to investigate the viability and costs for remote site meetings using technology in the Capitol and to provide information to the Co-chairpersons. Commissioner Stumpf seconded the motion. The motion carried.

Topics for future meetings may be submitted to staff. By mid-September, a dynamic model will be available from the KPERS Actuary and it will allow Commissioners to look at various policy options within the context of KPERS numbers to get ideas on how different policy options would impact KPERS and its financial condition.

Prepared by Connie Burns
Edited by Julian Efird

Approved by Commission on:

August 31, 2011
(Date)