MINUTES

JOINT COMMITTEE ON PENSIONS, INVESTMENTS, AND BENEFITS

November 27, 2017
Room 548-S—Statehouse

Members Present

Representative Steven Johnson, Chairperson
Senator Jeff Longbine, Vice-chairperson
Senator Larry Alley
Senator Laura Kelly
Senator Lynn Rogers
Representative John Barker
Representative Daniel Hawkins
Representative Jim Kelly
Representative Annie Kuether
Representative Richard Proehl
Representative Tom Sawyer

Members Absent

Senator Ty Masterson – Excused
Representative Broderick Henderson - Excused

Staff Present

Reed Holwegner, Kansas Legislative Research Department
Mark Dapp, Kansas Legislative Research Department
J.G. Scott, Kansas Legislative Research Department
Gordon Self, Office of Revisor of Statutes
David Wiese, Office of Revisor of Statutes
Lea Gerard, Committee Assistant

Conferees

David Wiese, Assistant Revisor, Office of Revisor of Statutes
Alan Conroy, Executive Director, Kansas Public Employees Retirement System
Nick Meyer, Assistant Revisor, Office of Revisor of Statutes

Others Attending

See Attached List.

Morning Session

Called to Order; Introductions; and Opening Remarks

Chairperson Johnson called the meeting to order.

The Committee recessed due to an evacuation of the building. After it was determined to be safe to return, the meeting reconvened.

Chairperson Johnson recognized David Wiese, Assistant Revisor, who briefed the Committee on its charge (Attachment 1), which is to monitor, review, and make recommendations relative to investment policies and objectives formulated by the Kansas Public Employees Retirement System (KPERS or the Retirement System) Board of Trustees (Board); review and make recommendations related to KPERS benefits; and consider and make recommendation on the confirmation of members nominated by the Governor to serve on the KPERS Board. Mr. Wiese stood for questions from the Committee.

2016 Valuation of Kansas Public Employees Retirement System

Alan Conroy, Executive Director, KPERS, prefaced his remarks by stating KPERS partners with more than 1,500 state and local government employers, serving more than 300,000 members (Attachment 2). KPERS, which is governed by a nine-member Board, administers three retirement plans: regular KPERS, Kansas Police and Firemen's Retirement System (KP&F), and the Judges' Retirement System.

The 2016 actuarial value of the Retirement System's assets is $18.256 billion. KPERS' estimated liability is $27.318 billion, leaving an unfunded actuarial liability (UAL) of $9.061 billion and a funded ratio of 66.8 percent. Compared to the 2015 valuation, the UAL increased by more than $522 million. The increase was mainly driven by a change in the assumed rate of investment return, which the Board decreased from 8.0 percent to 7.75 percent. For KPERS funding to remain at what Mr. Conroy described as a "steady state," state-school employer contributions in FY 2019 will need to be $623.5 million, which includes $98.6 million for the normal employer cost rate, $518.5 million for the UAL, and $6.4 million for the deferred school contribution of FY 2017.

Mr. Conroy said the other factor impacting the 2016 valuation was recent changes to employer contributions. Appropriation legislation in 2017 made several changes to the KPERS employer contribution amounts. The first change was a decision not to pay the quarterly contribution of $97 million from FY 2016 that was scheduled to be paid in FY 2018. Currently, $64 million of the FY2017 employer contributions will be paid over the next 20 years with 7.75 percent interest. The first payment was paid in July 2017. For FY 2019, one quarter of the employer contributions, $194 million, will be paid over 20 years plus 7.75 percent interest, starting in fiscal year 2020. He stated $388 million will be paid over the next 20 years, including interest. The payments of $64 million and $194 million are classified as long-term accounts receivable.

In response to Committee members' questions, Mr. Conroy stated smoothing of market losses caused the actuarially-required rate of contribution to increase. The $1.0 billion pension obligation bonds are reflected in this annual valuation.

Responding to a question from Senator Kelly, Mr. Conroy noted the nonpayment of employer contributions for the fourth quarter of FY 2016 contributed to the UAL.

In response to a question from Chairperson Johnson, Mr. Conroy stated the funded ratios for the state-school group were 55 percent in 2011 and 56 percent in 2012, at its lowest points. Looking back to 2000, the actuarial value was 89 percent funded.

Mr. Conroy observed there are concerns from pension members that the Legislature is spending funds after contributions have been made to KPERS. He said it is not possible because funds can never be removed from a trust fund like KPERS for any reason other than to pay the promised benefits to the members and pay expenses of the Retirement System. KPERS is protected by state and federal laws.

Committee discussion followed regarding whether the Legislature is legally bound to pay interest to KPERS on delayed employer contributions.

Representative Sawyer requested KPERS staff to analyze what the effect on the Retirement System would be if none of the remaining delayed employer contribution or interest payments were made. Senator Kelly requested an analysis assuming that principal only was paid to KPERS. Mr. Conroy said he would provide the information.

In response to a question from Representative Hawkins, Mr. Conroy stated the public policy goal is for KPERS to be 100 percent funded. Setting a lower mark would grow the unfunded liability.

Chairperson Johnson asked the members what they wanted to include in the Committee report. He suggested information be included in the report regarding the solvency of the Retirement System, which is able to provide for current beneficiaries, noting the amount of funding necessary to keep KPERS in a steady state in FY 2019. He also suggested the report note KPERS' assets are not accessible to the Legislature for re-appropriation.

The Committee recessed at 12:00 noon and reconvened at 1:30 p.m.

Afternoon Session

Update on Performance of Bond Proceeds, 2004 and 2015 Series Afternoon

Chairperson Johnson recognized Mr. Conroy, who provided an update on the pension obligation bonds (Attachment 3). Mr. Conroy stated the purpose of such bonds is interest arbitrage, which assumes the State will pay a lower interest on servicing the bonds than what KPERS' portfolio can earn over time. The State has issued two series of pension obligation bonds. The first was in 2004 for an amount of $500 million gross of fees (2004C bond issue), and the second was issued in 2015 for $1.0 billion net of fees (2015H bond issue). In 2004, the Legislature approved a $500 million bond issue, which was issued with a 30-year maturity and an interest cost of 5.39 percent. KPERS received $440,165,000 in net proceeds. Annual debt service is approximately $33 million from the Expanded Lottery Act Revenues Fund. In 2015, the Legislature approved a $1.0 billion bond issue, which was issued with a 30-year maturity and an interest cost of 4.68 percent. KPERS received $1.0 billion in net proceeds. Annual debt service is approximately $65 million from the State General Fund. The average annualized total

returns for the 2004C and 2015H bond issues are 7.38 percent and 7.95 percent, respectively. The two bond series have added approximately $332.9 million to KPERS (2004C: $259 million; 2015H: $73.9 million).

In response to a question from Senator Alley, Mr. Conroy stated the repayment of the bonds is not counted toward the UAL.

Overview of 2017 Legislation Enacted

Chairperson Johnson recognized Mr. Wiese, who provided an overview of legislation enacted during the 2017 Session (Attachment 4). Last year the Legislature passed House Sub. for SB 21, which amended several provisions pertaining to working after retirement. Mr. Wiese also pointed out a small piece in SB 205, which exempted certain employees of the Board of Regents who are covered by the Regents' retirement plan, which is not administered by KPERS, from working-after-retirement provisions. Mr. Wiese stood for questions from the Committee.

Implementation of New Provisions: Participating Service, KP&F, Working After Retirement

Mr. Conroy briefed the Committee on implementation of recently enacted legislation (Attachment 5). In terms of information technology and information shared with the KPERS members and employers, all is on track to implement changes made to working after retirement that start January 1, 2018. He noted the U.S. Internal Revenue Service's requirement regarding no prearrangement to return to work between the employer and retiree is still in place. If a KPERS member retires before age 62, there is a waiting period of 180 days before the retiree may return to work for an employer covered by regular KPERS. If a member retires at age 62 or older, the waiting period is 60 days. Now, there is no earnings limit on the individual, but the employer must make the statutory contribution on the first $25,000 of compensation and, after that amount, the contribution rate is 30 percent.

The Legislature passed SB 205, which pertains to the KP&F plan, changing the service-connected death benefit and service credit for employees returning from paid leave.

In response to a question from Chairperson Johnson, Mr. Conroy stated the working-after-retirement legislation has been positively received by the school districts.

Submission of KPERS Sudan Report

Mr. Conroy briefed the Committee on the Sudan Divestment Report for the time period ending September 30, 2017 (Attachment 6). In 2007, legislation was enacted that restricted the Retirement System's investments in companies engaged in business operations in Sudan. The statute also requires an annual report to the Committee. The exposure to investments with significant business operations in Sudan has remained low and consistent over time, which was estimated to be $55.7 million (0.29 percent) of the KPERS investment portfolio. Mr. Conroy said Kansas law contains a repeal section that triggers when "the United States revokes its current sanctions against Sudan." KPERS, in consultation with its outside legal counsel, as determined that President Trump's executive order issued on October 12, 2017, has revoked the

substantive portion of the sanctions mentioned in statute. Mr. Conroy noted the federal executive order lifted the economic sanctions, but there are a few provisions of the original sanctions, such as relating to diplomatic offices and agriculture products, that remain in place. The Legislature might consider repealing KSA 2016 Supp. 74-4921c and 74-4921d for purposes of clarity.

Chairperson Johnson recognized Gordon Self, Revisor of Statutes, who concurred with Mr. Conroy's assessment of the situation. The language of the statute does not match up perfectly with the actions taken at the federal level. Mr. Self suggested the most appropriate way to handle the situation would be to repeal the two statutes.

In response to a question from Senator Kelly, Mr. Self stated the State has not placed other investment prohibitions on KPERS. However, Mr. Self added, the Legislature did enact KSA 75-3740c (2017 HB2409), which pertains to companies' policies towards Israel. Before any state agency can do business with an outside vendor, that vendor must sign a document stating it is not discriminating against the State of Israel. Vendors under contract with KPERS, such as investment managers or advisers, would be required to sign such a statement.

Chairperson Johnson said the Committee should introduce legislation to repeal the obsolete language so as to make sure the intent is clear and consistent with the way KPERS manages the portfolio.

Senator Kelly suggested the Committee may want to consider exempting KPERS from the nondiscrimination documentation as a means to keep administrative costs down.

Investment Performance

Mr. Conroy provided an overview of KPERS investment performance, which is continued good news (Attachment 7). The third quarter of this year continued a strong performance in the equity market, particularly global markets. For the third quarter, KPERS experienced a return of 3.0 percent. All asset classes (domestic equity, international equity, and private equity markets) produced a positive return. This time period has been marked by an unusually low level of market volatility. KPERS has experienced eight consecutive years of positive returns. From October 2016 to October 2017, the Trust Fund has grown by about $1.8 billion. Currently, KPERS' portfolio is worth more than $19 billion.

Chairperson Johnson stated both the dollar amount and total percentage returns are encouraging. The Board has done an exceptional job of diversifying and managing risk in the portfolio.

Committee Discussion and Report to the 2017 Legislature

Chairperson Johnson stated one of the questions on which the Supreme Court was silent in its recent ruling on school funding was whether KPERS employer contributions should count in education funding.

Chairperson Johnson recognized Nick Meyers, Assistant Revisor, who briefed the Committee on the court's consideration of KPERS funding as it relates to education. The decision in *Gannon I* is the first time the Supreme Court stated there should be consideration

given for KPERS payments. State moneys invested in the Retirement System may be a valid consideration because it is a factor in attracting and retaining quality educators. After the first decision, the next two panel decisions continued to exclude KPERS payments from their calculations of what an adequate school finance system would look like. In *Gannon IV*, the Supreme Court again said the lower court should give some consideration to KPERS. It made a statement there is some value to the thousands of individual recipients in the education system, and it helps to have a competitive environment in Kansas schools. In *Gannon V*, which was issued in October 2017, the Supreme Court was silent on KPERS funding.

By consensus, the Committee agreed to include the following information, conclusions, and recommendations in its report to the 2018 Legislature:

- Note the minimum annual employer contribution for the state-school group ($623.5 million) that is necessary to meet the Retirement System's liability without increasing the UAL;

- Note the secure nature of assets that have been contributed to KPERS;

- Suggest the Legislature consider the extent to which state contributions to KPERS on the behalf of school districts should be counted towards education funding;

- Note changes to the federal tax code could impact KPERS and congressional actions should be monitored;

- Include investment performance data from previously issued pension obligation bonds, noting the repayment of those bonds is not part of the UAL;

- Commend the KPERS Board and its staff on the historical investment returns;

- Introduce legislation repealing KSA 2016 Supp. 74-4921c and 74-4921d; and, during the hearing process, the Legislature should consider exempting KPERS from similar statutes that may increase operational expenses; and

- Request KPERS staff provide the Legislature during the 2018 Session with the following:

    - An analysis of the impact on the UAL if the State paid the delayed employer contributions but without the payment of interest;
    - An analysis of the impact on the UAL if the State did not pay the delayed employer contributions and interest;
    - Clarification on the minimum amount necessary to be paid in FY 2019 for the state-school group so as not to adversely affect the Retirement System; and
    - Estimate a re-amorization schedule, over a new 30-year period, using existing data.

Chairperson Johnson thanked Faith Loretto, Planning and Research Officer, KPERS, for her service to the Retirement System and the Legislature. Ms. Loretto will be retiring.

The Committee adjourned.

Prepared by Lea Gerard
Edited by Reed Holwegner

Approved by the Committee on:

January 18, 2018
(Date)