

Report of the Joint Committee on Pensions, Investments and Benefits to the 2018 Kansas Legislature

CHAIRPERSON: Representative Steven Johnson

VICE-CHAIRPERSON: Senator Jeff Longbine

OTHER MEMBERS: Senators Larry Alley, Laura Kelly, Ty Masterson, and Lynn Rogers; and Representatives John Barker, Daniel Hawkins, Broderick Henderson, Jim Kelly, Annie Kuether, Richard Proehl, and Tom Sawyer

CHARGE

The Committee is to consider the following:

- Legislation enacted during the 2017 Session affecting the Kansas Public Employees Retirement System (KPERS or Retirement System), particularly House Sub. for SB 21, which provides new working-after-retirement provisions;
- Performance of the pension obligation bonds issued in 2004 (\$500 million) and 2015 (\$1.0 billion);
- The overall funding ratio for the Retirement System;
- Various reports statutorily required to be submitted by KPERS to the Committee; and
- To fulfill the Committee's duties and responsibilities, as provided by KSA 2017 Supp. 46-2201, to monitor, review, and make recommendations regarding the Retirement System.

Joint Committee on Pensions, Investments and Benefits

ANNUAL REPORT

Conclusions and Recommendations

The Committee notes, assuming all assumptions are met in the future, the Kansas Public Employees Retirement System (KPERS) would be fully funded by the end of 2036. To meet this goal, the employer contributions for the state-school group would need to be \$623.5 million in FY 2019. The Committee notes those funds deposited in the KPERS Trust Fund are protected by state and federal law, and they are not subject to legislative reappropriation.

The Committee recommends the Legislature consider, during its deliberation during the 2018 Session, the extent to which State contributions to KPERS on the behalf of school districts should be counted towards education funding.

All asset classes (domestic equity, international equity, and private equity markets) produced a positive return in the third quarter of 2017. 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. The Committee commends the KPERS Board and its staff for the historic returns the investment portfolio has achieved.

The Committee recommends the new changes to the federal tax code be evaluated to determine whether KPERS will be impacted.

The Committee notes the State has issued two pension obligation bonds. The average annualized total return 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, \$259.0 million; 2015H, \$73.9 million). The Committee adds that while the arbitrage has been successful, the debt service is not part of the unfunded actuarial liability.

The Committee concurs with KPERS' conclusion that KPERS is no longer prohibited from investing in companies that have a business presence in Sudan, even though some of the minor federal restrictions are still in place. Therefore, to ensure there is clarity in the future, the Committee introduces legislation that would repeal KSA 2017 Supp. 74-4921c and 74-4921d. The Committee notes the monitoring of the divestment policy has been an expense to KPERS. The Committee suggests, during the hearing process, the Legislature should consider exempting KPERS from KSA 2017 Supp. 75-3740e, pertaining to vendors' policies towards Israel, which may increase operational expenses.

The Committee requests KPERS to provide various analyses, which are described in this report, during the 2018 Session to the standing committees of the House and Senate that are responsible for retirement policy.

Proposed Legislation: A bill that would repeal the obsolete provision that prohibits the Retirement System from investing in Sudan and related reporting requirements to the Committee.

BACKGROUND

The Joint Committee on Pensions, Investments and Benefits, created in 1992, is authorized by KSA 2017 Supp. 46-2201 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 recommendations on the confirmation of members nominated by the Governor to serve on the KPERS Board.

The Committee may introduce legislation it determines to be necessary.

COMMITTEE ACTIVITIES

The Committee met on November 27, 2017, to review KPERS long-term funding, the performance of pension obligation bonds, newly enacted legislation, and investment performance. The Committee acknowledged receipt of information submitted by KPERS and introduced legislation.

Review of KPERS Long-term Funding

The Committee reviewed the 2016 actuarial valuation, which is a snapshot of the financial condition of the Retirement System as of December 31, 2016. The actuarial value was estimated to be \$18.256 billion. Actuarial assets are calculated by “smoothing” investment gains and losses over a five-year period. A market value higher than the actuarial value means that deferred investment gains will flow through valuations over the subsequent four years. There is an estimated \$566 million in net deferred loss to be realized in the outlying years. A year ago, the net deferred loss was \$515 million.

The funding status has improved for one of the five membership groups: the local government group. The funded ratio for the groups of KPERS state, school, Judges’ Retirement System, and the Kansas Police and Firemen’s Retirement System has decreased. The Retirement System’s overall funded ratio decreased from 67.1 percent in 2015 to 66.8 percent in 2016. The unfunded actuarial liability (UAL) for the entire Retirement System increased in 2016 by \$522 million, leaving \$9.061 billion to be funded. Changes in actuarial assumptions and a decrease in the assumed rate of return, from 8.00 percent to 7.75 percent, have diminished KPERS’ solvency. If all assumptions are met in the future, KPERS should be fully funded at the end of 2036. For KPERS funding to remain at 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.

Bond Proceeds

The purpose of pension obligation bonds is arbitrage, which assumes the State will pay a lower interest on servicing the bonds than what the KPERS’ portfolio can earn over time. The State has issued two 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 million in net proceeds. Annual debt service is approximately \$33.0 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 \$65.0 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, \$259.0 million; 2015H, \$73.9 million).

Overview of 2017 Legislation Enacted; Implementation of New Provisions

Staff from the Office of Revisor of Statutes provided an overview of House Sub. for SB 21, which amended several provisions pertaining to working after retirement, and SB 205, which, in part, 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.

KPERS staff, noting the working-after-retirement legislation has been positively received by the school districts, said all is on track to implement changes to working after retirement that start January 1, 2018.

Receipt of KPERS Reports

The Committee acknowledged receipt from KPERS of the statutorily required Sudan Divestment Report. 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, or 0.29 percent, of the total KPERS investment portfolio.

In 2007, legislation was enacted that restricted the Retirement System's investments in companies engaged in business operations in Sudan. The statute also imposed an annual reporting requirement to the Committee. KPERS staff explained Kansas law contains a repeal provision that triggers when the United States revokes its current sanctions against Sudan. KPERS, in consultation with its outside legal counsel, has determined the presidential executive order issued on October 12, 2017, has revoked the substantive portion of the sanctions mentioned in statute, but a few provisions of the original sanctions, such as relating to diplomatic offices and agriculture products, remain in place. KPERS suggested the Legislature might consider repealing KSA 2017 Supp. 74-4921c and 74-4921d for purposes of clarity.

Investment Performance

The third quarter of 2017 continued a strong performance in the equity markets, especially in the global market. 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 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 grew by about \$1.8 billion. Currently, the KPERS portfolio has a market value of more than \$19 billion.

CONCLUSIONS AND RECOMMENDATIONS

The Committee notes, assuming all assumptions are met in the future, KPERS would be fully funded by the end of 2036. To meet this goal, the employer contributions for the state-school group would need to be \$623.5 million in FY 2019, 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.

While in recent years there have been reductions to employer contributions deposited to the KPERS Trust Fund, once those moneys are deposited, those funds may be used solely for the benefit of the KPERS members and the administration of the Retirement System. The Committee notes those funds are protected by state and federal law, and they are not subject to legislative reappropriation.

The Committee recommends the Legislature, during its deliberation during the 2018 Session, consider the extent to which state contributions to KPERS on the behalf of school districts should be counted towards education funding. The Supreme Court has suggested KPERS contributions should, at the least, be considered, but to date no court decision has addressed the utility of KPERS

The third quarter of 2017 continued strong investment performance. All asset classes (domestic equity, international equity, and private equity markets) produced a positive return. 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. The Committee commends the KPERS Board and its staff for the historic returns the investment portfolio has achieved.

The Committee recommends the new changes to the federal tax code be evaluated to determine whether KPERS will be impacted.

The Committee notes the State has issued two 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 \$33.0 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 \$65.0 million from the State General Fund. The average annualized total return 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, \$259.0 million; 2015H, \$73.9 million). The Committee adds that while the arbitrage has been successful, the debt service is not part of the UAL.

Upon receipt of the annual Sudan Divestment Report, the Committee received notice from KPERS that the substantive portion of the sanctions have been lifted by presidential executive order. The Committee concurs with KPERS' conclusion that KPERS is no longer prohibited from investing in companies that have a business presence in Sudan, even though some of

the minor federal restrictions are still in place. Therefore, to ensure there is clarity in the future, the Committee introduces legislation that would repeal KSA 2017 Supp. 74-4921c and 74-4921d. The Committee notes the monitoring of the divestment policy has been an expense to KPERS. The Committee suggests the Legislature should consider, during the hearing process, exempting KPERS from KSA 2017 Supp. 75-3740e, pertaining to vendors' policies towards Israel, which may increase operational expenses.

The Committee requests KPERS provide the following information during the 2018 Session to the standing committees of the House and Senate that are responsible for retirement policy:

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