Report of the Joint Committee on Pensions, Investments and Benefits to the 2021 Kansas Legislature

Chairperson: Senator Jeff Longbine

Vice-chairperson: Representative Steven Johnson

Other Members: Senators Rick Billinger, Vic Miller, Pat Pettey, and Mary Jo Taylor; Representatives Doug Blex, Brenda Dietrich, Broderick Henderson, Jim Kelly, Annie Kuether, Brett Parker, Sean Tarwater, and Rui Xu (substitute member)

Charge

To fulfill the Joint Committee's duties and responsibilities, as provided by KSA 46-2201, the Joint Committee will monitor, review, and make recommendations regarding the Kansas Public Employees Retirement System (KPERS or Retirement System).

December 2020

Joint Committee on Pensions, Investments and Benefits

Annual Report

Conclusions and Recommendations

The Joint Committee submits the following comments and recommendations.

- **Annual valuation report and total fund performance.** The Joint Committee commends the outstanding work of the Kansas Public Employees Retirement System (KPERS) Board of Trustees and KPERS staff in the continued improvement of the unfunded actuarial liability (UAL). The Joint Committee recommends meeting funding requirements and working with KPERS on its cash position needs to provide certainty and funding. The Joint Committee further recommends to not reamortize prior to the ten-year mark (presently, the legacy UAL will extinguish in 2033) unless such recommendation comes from the KPERS Board of Trustees.

- **Board of Trustees and KPERS administration.** The Committee supports the modernization of the KPERS pension administration system.

- **Deferred Retirement Option Program (DROP) audit review, comment, and legislation.** The Joint Committee recommends retaining only those eligible employees of the Kansas Highway Patrol and Kansas Bureau of Investigation in the DROP until the current statutory sunset date of January 1, 2025, in order to gain additional information about these participants and allow the Legislature to evaluate the cost and success of the program before considering expansion to other Kansas Police & Firemen's Retirement System (KP&F) agencies.
  - The Joint Committee recommends the introduction of legislation that would allow participants to extend their (currently) locked-in periods of participation (three years, four years, or five years chosen at sign-up for the program). Further, the Committee requests a fiscal estimate, prior to the 2021 Legislative Session, from the KPERS staff regarding the costs associated with this proposal. [House bill]

- **Legislation.** The Committee recommends the introduction of legislation during the 2021 Legislative Session to bring the KPERS' Internal Revenue Code guidepost section into compliance with the relevant federal Coronavirus Aid, Relief, and Economic Security (CARES) Act provisions and further recommends legislation to update the 457 plan's companion 401(a) plan language in KPERS statutes. [Senate bill]

- **Legislation.** The Committee recommends reintroducing provisions of 2020 HB 2452, pertaining to death and disability benefits and service-connected deaths. [House bill]

- **Working-after-retirement statutes and emergency management.** The Joint Committee notes its discussion regarding the impacts of the COVID-19 pandemic on KPERS staff and the administration of retirement benefits. The Committee discussed working-after-retirement provisions and the temporary waiver of the required waiting period.

As the 2021 Legislature considers the broader topic of emergency management, the Joint Committee notes modifications to KPERS statutes regarding working after retirement should be considered, given the recent waiver of such requirements during the pandemic (*i.e.,* waiting period, opening and closing date, and timing of the expiration date when either the disaster declaration has ended or a school year or semester completes). The Committee notes its discussion regarding whether such potential legislation would involve only KPERS or a broader issue of the Kansas Emergency Management Act or Executive Orders of the Governor. There also was discussion on, if the decision is KPERS-specific, whether the Legislature, the KPERS Board of Trustees, or the State Board of Education would have the ability to make the waiting period change. The Committee discussed providing guidance should a pandemic occur. The Committee finds clarity and consistency is needed to allow, in such circumstances, certain employers to fill job needs.

- **KP&F Participation.** The Joint Committee encourages individual standing committees of the Legislature to continue discussion on possible additions to the KP&F. The Committee acknowledges it prior study and recommendation in 2019 regarding the transfer of employee groups into different KPERS plans and future study topics (*e.g.*, state and local correctional groups). The Committee also recognizes ongoing work on a legislative solution for certain employees of the Kansas Department of Wildlife, Parks and Tourism and encourages this option be examined by the legislative committee before consideration of movement to KP&F.

- **Retirement System–Tier 3 Formula.** The Committee recommends the ongoing review of the Tier 3 dividend formula to provide equity as intended.

Proposed Legislation: The Committee requests the introduction of three bills.

Background

The Joint Committee on Pensions, Investments and Benefits, created in 1992, is authorized by KSA 2019 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;

- Consider and make recommendations on the confirmation of members nominated by the Governor to serve on the Board; and

- Introduce legislation it determines to be necessary.

The Legislative Coordinating Council authorized the Joint Committee to meet on one day.

Committee Activities

The Committee met on December 2, 2020, to receive reports and updates from the Post Auditor on the Deferred Retirement Option Program (DROP) and audit findings; the KPERS administration and the KPERS Board of Trustees on the December 31, 2019, annual valuation and pension bond performance, investment performance, and the KPERS Tier 3 dividend formula; and committee staff on recent retirement benefits legislation. The Committee also requested and received comment on potential impacts of the COVID-19 pandemic on the Retirement System (investments and the economy and the administration of benefits) and on the KPERS agency operations.

2019 Valuation of KPERS

The Committee reviewed the latest actuarial valuation, which serves as a snapshot of the financial condition of the Retirement System as of December 31, 2019. The Executive Director of KPERS characterized the report overall as good news, with several indicators moving in the right direction. [*Note:* This annual actuarial valuation, which measures assets and liabilities, provides the basis for calculating future employer contribution rates. The 2019 valuation is used to set the fiscal year (FY) 2023 contribution rates for State/School employers and calendar year (CY) 2022 contribution rates for local employers and serves as the baseline for any cost studies in the 2021 Legislative Session.]

As of December 31, 2019, the actuarial value was estimated to be $20.976 billion. Actuarial assets are calculated by averaging, or "smoothing," investment gains and losses over a five-year period. There is a net deferred loss of $568 million to be realized in the outlying years. Net investments on a calendar-year basis were 17.1 percent (market value). Due to smoothing, the return on actuarial assets was 6.7 percent.

The Retirement System's overall funded ratio of assets to liabilities improved from 68.4 percent (2018 valuation) to 70.0 percent. (The standards for public pension plans suggest a retirement system should be funded between 80.0 and 100.0 percent of future liabilities owed.) The unfunded actuarial liability (UAL) for the Retirement System decreased from $9.2 billion (2018 valuation) to $9.0 billion; the total actuarial liability is $29.98 billion. For KPERS funding to remain at a "steady state," State/School Group employer contributions in FY 2021 will need to be $626.2 million, which includes $93.2 million for the normal employer cost rate, $507.2 million for the UAL, and $25.8 million for the deferred school contributions of FY 2017 and FY 2019.

The report further indicated the actuarially required contribution (ARC) rates for KPERS State/School employers decreased from 14.09 percent in FY 2022 to 13.86 percent in FY 2023. The statutory employer contribution for the State/School group is 14.23 percent in FY 2021, and this contribution is equal to the ARC rate in FY 2021 for the first time in 25 years. It was noted the Legislature approved additional contributions to KPERS in 2018 and 2019. The additional contributions totaled $304 million over two years with $134 million received for CY 2018 and $166 million received during CY 2019. The funds were directed to the School group UAL but impacted the funding for the State/School group. Additional contributions lowered the State/School employer contribution rate by 0.36 percent in FY 2021 and 0.29 percent in FY 2022. The Committee and the Executive Director discussed the funding projections presented, the anticipated investment experience and overall portfolio assumptions, and the timing of potential future reamortization in relationship to the legacy UAL timeline (2033).

Investment Performance of Bond Proceeds

Pension obligation bonds serve as a form of arbitrage intended to reduce future employer contributions and improve the solvency of KPERS. The pension obligation bond proceeds improve the funded status of the Retirement System. The State has issued two pension obligation bond series. The first was in 2004 for a total 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 $500.0 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 (SGF).

The average annualized total returns for the 2004C and 2015H bond issues, as of September 30, 2020, were 7.13 percent and 6.82 percent respectively. As of October 31, 2020, the two bond series had added approximately $473.0 million to KPERS (2004C, $332.0 million; 2015H, $141.0 million).

Investment Performance of the KPERS Portfolio; COVID-19 Impacts

At the end of FY 2020, the net asset market value of the portfolio was more than $20.190 billion. The gross return of the total portfolio, which consists of domestic equity, international equity, fixed income, yield driven, real return, cash, real estate, and alternative investments, was 2.1 percent, which was 0.3 percent below the benchmark. The Chief Investment Officer (CIO), KPERS, further reviewed the total fund performance through June 2020, and highlighted the best-performing asset classes for FY 2020: fixed income, real return, and domestic equity, generating returns of 8.7 percent, 7.5 percent, and 6.5 percent respectively. For the trailing returns of the past 3-, 5-, 10-, and 25-year periods, the portfolio has surpassed its respective benchmarks. The CIO commented the FY 2020 performance could be characterized by high market volatility and low returns.

Addressing the topic of the COVID-19 pandemic, the CIO stated the current investment environment has massive uncertainty related to the global pandemic and cited both positive and negative indicators present in the economic environment. She also reported the investment team had been working remotely since March 23, and in general, the industry has moved to a work-from-home environment. This limits investment manager relationships to general partners and a number of fundraisings (private equity) have been delayed. She also addressed risk mitigation strategies and stress-testing scenarios. The CIO and the Committee reviewed available FY 2021 data (as of October 31, 2020), which indicated both July and August were positive months with a consistent portfolio index over 3.0 percent, and September and October were negative months due to market volatility. For the calendar year to October 31, 2020, the total return is 4.2 percent short of the return on investment. It was noted the S&P 500 was up 11 percent in November, and the estimated performance could possibly be around 7.0 percent, which would help the annual valuation for CY 2020.

COVID-19 Impact on KPERS Operations and Retirements

The Executive Director, KPERS, provided information on the COVID-19 pandemic's impacts on operations and retirements. In 2020, there has been an increase in the number of retirements compared to the number in prior years. He noted it was unknown how much of the increase is due to COVID-19, but it is a key factor. The number of new applications for retirements and survivor benefits was 1,087 in September and October 2020, compared with 846 retirement applications processed during the same two-month period in 2019. He noted the 28.5 percent increase may have been due to early retirement incentives, a reluctance to return to work or to continue virtual employment during the pandemic, or a lack of actual work (and compensation) for certain school employees. The number of January 2021 retirement applications submitted as of November 23, 2020, was 28.9 percent higher than the number submitted as of that same date in 2019. The Executive Director further discussed the most significant increase of new retirees was for School group members, which had year-over-year increase of 185 retirements, or nearly 48 percent, for the month of September and October. The State group only experienced an increase of 56 retirements, or 12.2 percent. The Executive Director reviewed the other area where KPERS is seeing a large increase—withdrawal applications. The number of withdrawal payments increased to 3,517 in September and October 2020, 1,756 more than the 1,761 payments issued in September and October 2019, a nearly 100 percent increase. Most of the withdrawals are due to financial challenges of the COVID-19 pandemic or may result from an internal project notifying inactive, non-members that accounts are no longer eligible for interest credits.

The Executive Director indicated it is unclear whether or how long the increases in applications and withdrawals will continue. He also highlighted virtual pre-retirement seminars and efforts to increase remote work opportunities for KPERS staff. In terms of day-to-day operations, the Executive Director noted efforts to add plexiglass barriers, focus on remote working, and keep minimum staffing levels on-site. He reported the building had been closed to the public since November 23. The Committee and the Executive

Director discussed working-after-retirement changes made to accommodate the pandemic and employer needs. The Executive Director stated under the Governor's Executive Order issued in March 2020, if the school employer wanted to hire back a KPERS retiree due to the COVID-19 pandemic, there was the ability to suspend the working-after-retirement waiting period through the end of the school year.

Data provided subsequent to the meeting by the KPERS staff, indicates, as of December 7, KPERS has received waiver requests from 29 employers (out of 1,526 participating employers), including 3 local employers and 26 school districts and educational cooperatives. The requests are primarily for teaching positions, but the local employer requests include a detention facility and a local hospital. KPERS further reports some employers are requesting specific, individual positions for waiver while others have request a waiver for a list of retirees that may or may not have been hired (therefore, an exact count of affected retirees cannot be made available). The maximum number of retirees included in such waiver requests is 142 (115 school employees and 27 local employees).

Deferred Retirement Option Program (DROP) and Audit Report

The Executive Director, KPERS, provided information on the DROP for Kansas Police & Firemen's Retirement System (KP&F) members in the Kansas Highway Patrol (KHP) and the Kansas Bureau of Investigation (KBI). Under DROP, eligible members with normal unreduced retirement initiate the calculation of retirement benefits, but choose to defer the actual receipt of the benefits for a three-, four-, or five-year period. During the DROP period, the member does not earn additional service credits but continues to work and contribute 7.15 percent of compensation into DROP. The KHP or KBI continues to make employer contributions to KP&F. Retirement benefits are held in a separate account, and at the end of the period, the member receives the lump sum with interest. The DROP account can earn interest according to a statutory formula, and currently the formula allows for 3.0 percent interest in any year in which KPERS investments reach the 7.75 percent investment return assumption. The DROP, which was created as a five-year pilot program in 2015 and was expanded to include certain KBI employees in 2019, has a statutory sunset date of January 1, 2025.

During Committee discussion, the Executive Director confirmed DROP was created to assist the KHP with recruitment and retention. He also reviewed the circumstances in which DROP participants would be (*e.g.,* terminate employment) or would not be (*e.g.,* changing from a three-year to five-year option) permitted to elect changes in their DROP arrangement. It was noted if the member withdraws from the DROP program, the accrued benefit is set aside, and any interest earned would be forfeited. KPERS staff later confirmed of the 44 DROP participants, 7 selected the 3-year option, 2 selected the 4-year option, and 35 selected the 5-year option.

The Post Auditor reviewed a performance audit, which was authorized by the Legislative Post Audit Committee in April 2020 and published in September 2020, evaluating the DROP. He noted the audit objective was to answer the following questions:

- How does the Deferred Retirement Option Program affect state agencies?
- How does Kansas' Deferred Retirement Option Program compare to similar programs in other public pension plans?

The Post Auditor stated, of the retirement-eligible KP&F members surveyed, there were 39 participants in the DROP (35 KHP members and 4 KBI members). He further noted the DROP has a very limited number of participants, and out of 7,500 employees covered under the KP&F plan, only KHP and KBI employees are allowed to participate. The cost for the participating employers and KPERS to administer the DROP in its current form is very low and designed to be cost neutral to the KP&F plan. The Post Auditor reported a survey was sent to a 111 eligible current and former employees, including both DROP participants and non-participants, and of the 60 responses received, 28 came from DROP participants who acknowledged the program influenced their retirement decisions. The Post Auditor indicated the DROP was shown to be more effective in retaining higher-ranking administrative staff, such as captains and majors, which represent 36 percent of KHP DROP participants. The DROP is less effective for retaining staff in the counties that are understaffed, and 8 participants have come from 6 of the 65 understaffed counties KHP initially identified in 2015. He noted the Kansas DROP was compared to four other programs in other states that were designed to be cost neutral to the respective retirements systems with both similarities and differences. Committee discussion with the Post Auditor focused on permitting additional groups to enter the DROP before its statutory sunset in 2025.

Overview of 2020 Legislation

Staff of the Office of Revisor of Statutes (Revisor) provided an overview of KPERS policy and funding bills that had committee consideration during the 2020 Legislative Session. The Revisor staff noted no legislation on these topics was enacted into law during the shortened session, but the following bills and topics received consideration:

- HB 2452 would have provided additional benefits for a KP&F tier II member's spouse and children under the age of 18, or under the age of 23 if the child is a full-time student, if the member dies from a service-connected disability.
- HB 2619 would have adjusted the frequency of the KPERS actuarial experience study from once every three years to once every four years (the Senate Substitute for this bill, on a topic related to financial institutions, was vetoed by the Governor).
- SB 269 would have increased the mandatory retirement age for judges to 80 years of age.
- HB 2503/SB 321 would have amortized the State/School KPERS group UAL over a 25-year period; authorized the transfer of $268,412,000 from the SGF to the KPERS fund during fiscal year 2020; and eliminated certain level-dollar employer contribution payments.
- SB 368 would have transferred $268,412,000 from the SGF to the KPERS Fund in FY2020 to pay the remaining balance of delayed KPERS State/School employer contributions from FY 2017 and FY 2019. The bill also would have eliminated the level-dollar employer contribution payments of $6.4 million and $19.4 million per year for 20 years that became statutory requirements after FY 2017 and FY 2019 employer contribution delays.

KPERS 3 Dividend Formula

The Planning and Research Officer, KPERS, provided information on the KPERS 3 dividend credit, which was part of 2012 law creating a cash balance plan. Differing from KPERS 1 and 2 plan design, the cash balance retirement plan is based on the member's contributions and earning retirement credits from the employer, which are tracked throughout the member's career. Interest is applied to the two accounts, and the benefit is based on the total account balance at retirement and has nothing to do with the number of years worked or finalized average salary. The two components of interest that is credited under the cash balance plan are the guaranteed portion and the dividend. The KPERS 3 dividend was originally structured as a discretionary dividend credit that could be provided by the Board. In 2014, enactment of HB 2533 resulted in two adjustments to the interest crediting in KPERS 3 plan design: reducing the guaranteed interest credit rate on the member and employer accounts from 5.25 percent to 4.0 percent and replacing the discretionary dividend credit language with a formulaic dividend design. The current dividend design (KSA 74-49,306) is equal to 75.0 percent of the 5-year average net compound rate of return above 6.0 percent, as determined by the Board for each calendar year and the 4 preceding years. CY 2019 was the fifth year of the KPERS 3 plan and the first year there was a five-year rolling average. The dividend is reviewed by the Board each March, and over the first five years of KPERS 3, the formulaic interest dividend credit has applied twice.

KPERS Board of Trustees Priorities

The Executive Director, KPERS, presented an overview of the Board activities and noted the Board reviewed possible technical, budget, and policy items during its November meetings. Consistent with Board policies, the Board is not recommending any policy changes in terms of benefit enhancements, leaving the decision to the Legislature. The Board has directed KPERS staff to pursue introduction of legislation for a technical update of KPERS guidepost statutes. In addition, the Board has approved a multi-year modernization of the KPERS pension administration system. The Board was advised by KPERS' tax and compliance counsel to update the KPERS' Internal Revenue Code guidepost section (KSA 74-49,123) during the 2021 Session to align with the federal Coronavirus Aid, Relief, and Economic Security (CARES) Act provisions pertaining to certain retirement plans. The counsel also recommended updating the 457 plan's companion 401(a) plan language in KPERS statutes.

The Executive Director stated the highest priority for the 2021 Legislative Session is modernization of the pension administration system. KPERS maintains a pension administration system that provides the functionality needed to collect data and contributions from employers and to process and pay benefits. KPERS started using the system in 2005. The existing system remains capable of providing processes such as collecting contributions and paying benefits but, due to the required customizations over the years, has become less efficient and more unstable over time. KPERS administration and the Board made the decision to begin the multi-year modernization effort with the FY 2021 budget. The Executive Director noted the 2020 Legislature authorized the system assessment, which was completed in September 2020 by the Segal consulting firm. The modernization project will likely extend over four or five fiscal years with a total cost between $20 million and $30 million from the KPERS Trust Fund. The KPERS budget request for the upcoming budget cycle includes $11.9 million over two years ($6.6 million in FY 2022 and $5.3 million in FY 2023) for this project.

Conclusions and Recommendations

The Committee submits the following comments and recommendations:

- **Annual valuation report and total fund performance.** The Committee commends the outstanding work of the KPERS Board of Trustees and KPERS staff in the continued improvement of the unfunded actuarial liability. The Joint Committee recommends meeting funding requirements and working with KPERS on its cash position needs to provide certainty and funding. The Joint Committee further recommends to not reamortize prior to the ten-year mark (presently, the legacy UAL will extinguish in 2033) unless such recommendation comes from the KPERS Board of Trustees.

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2021 Legislative Session to bring the KPERS' Internal Revenue Code guidepost section into compliance with the relevant federal CARES Act provisions and further recommends legislation to update the 457 plan's companion 401(a) plan language in KPERS statutes.

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