Report of the Joint Committee on Pensions, Investments and Benefits to the 2023 Kansas Legislature

CHAIRPERSON: Senator Jeff Longbine

VICE-CHAIRPERSON: Representative Steven Johnson

OTHER MEMBERS: Senators Brenda Dietrich, Michael Fagg, Cindy Holscher, Pat Pettey, Tom Holland (substitute), and Mary Ware (substitute); and Representatives Jesse Borjon, Broderick Henderson, Jim Kelly, Cindy Neighbor, Sean Tarwater, Carl Turner, and Rui Xu

CHARGE

Monitor, Review, and Make Recommendations Regarding the Retirement System

KSA 2022 Supp. 46-2201 directs the Committee to monitor, review, and make recommendations regarding investment policies and objectives formulated by the Kansas Public Employees Retirement System (KPERS) Board of Trustees; review and make recommendations relating to benefits for KPERS members; consider and make recommendations relating to the confirmation of members of the KPERS Board; review and make recommendations relating to the inclusion of city and county correctional officers as eligible members of the Kansas Police and Firemen's Retirement System; and review reports regarding working after retirement exceptions (KSA 74-4914 and 74-4937).

January 2023

Joint Committee on Pensions, Investments and Benefits

ANNUAL REPORT

Conclusions and Recommendations

The Joint Committee on Pensions, Investments and Benefits (Committee) submits the following conclusions and recommendations.

- **Joint Select Committee.** The Committee recommends that legislative leadership establish a joint Select Committee to evaluate KPERS Tier 3. The Committee recommends the Select Committee review the performance of Tier 3, determine whether the Cash Balance plan is fulfilling its intended purpose, and consider whether any adjustments need to be made to provide the equity as intended and the overall benefit value.

- **Extraordinary KPERS payment.** The Committee recommends the appropriate standing committees of the 2023 Legislature review using some of the projected State General Fund surplus ending balance to make additional contributions toward the reduction of KPERS unfunded actuarial liability.

- **Legislative Post Audit performance audit topics.** Pursuant to KSA 46-1136, the Committee proposes the Legislative Post Audit Committee consider the same topics as recommended by KPERS in its update: working after retirement, Kansas Police and Firemen's coverage for KPERS corrections members, and KPERS cost-of-living adjustments (COLAs). The Committee states the working-after-retirement topic is the lowest priority of the three suggested performance audit topics.

- **Alternate investment allocation cap removal (bill request).** The Committee will introduce a bill to remove the statutory cap of 15.0 percent and provide flexibility for the KPERS Board of Trustees to establish, by policy, a more relevant allocation cap on its alternate investments.

- **KPERS COLA option (bill request).** The Committee recommends reintroduction of the provisions of 2022 HB 2612 that provide a self-funded COLA option for new retirees. This option is similar to the option currently provided for Tier 3 members.

Proposed Legislation: Two bills: alternative investments (Senate); self-funded COLA (House).

BACKGROUND

The Joint Committee on Pensions, Investments and Benefits (Committee), created in 1992, is authorized by KSA 2022 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 Committee to meet on one day.

Committee Activities

The Committee met on December 2, 2022, to receive reports and updates from the KPERS administration on the December 31, 2021, actuarial valuation, performance of the pension obligation bonds, the KPERS Tier 3 dividend formula and experience, and membership and retirement trends, and to discuss the Board's alternative investments request and possible topics for study by the Legislative Division of Post Audit. The Committee also received updates on recent pensions law and legislative proposals, investment performance and select investment policy topics, and pension administration system modernization.

KPERS 2021 Actuarial Valuation Report

The Committee reviewed the latest actuarial valuation, which serves as a snapshot of the financial condition of the Retirement System as of December 31, 2021. The Executive Director of KPERS (Executive Director) 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 2021 valuation is used to set the fiscal year (FY) 2025 contribution rates for State/School employers and calendar year (CY) 2024 contribution rates for local employers, and it serves as the baseline for any cost studies performed in the 2023 Legislative Session.

Key Findings

Assets. As of December 31, 2021, the actuarial value of assets totaled $24.8 billion. Actuarial assets are calculated by averaging, or "smoothing," investment gains and losses over a five-year period. There is a net gain of almost $2.1 billion to be realized in the outlying years. Net investments on a calendar-year basis were 15.7 percent (market value). Due to smoothing, the return on actuarial assets was 10.9 percent.

Funded ratio and unfunded actuarial liability; "steady state" calculation. The Retirement System's overall funded ratio of assets to liabilities declined from 72.5 percent (2020 valuation) to 71.6 percent. [*Note:* The standards for public pension plans suggest a public 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 increased from $8.5 billion (2020 valuation) to $9.8 billion. The Executive Director noted the change in the investment return assumption (detailed later in this report) increased the calculated actuarial liabilities by $2.7 billion.

He also noted that for funding to remain at a "steady state," State/School Group employer contributions in FY 2023 will need to be $631.6 million, which includes $149.1 million for the normal employer cost rate and $482.5 million for the UAL.

Contribution rates. The report further indicated the actuarially required contribution (ARC) rates for KPERS State/School employers decreased from 12.47 percent in FY 2024 to 11.42 percent in FY 2025, primarily due to positive investment returns. The statutory employer contribution rate continues to be at the full ARC rate for FY 2025, the fifth consecutive year the statutory and actuarial rates have been equal. It was noted the Legislature approved additional contributions to KPERS in 2018 and 2019. The additional contributions totaled $304.0 million over two years with $138.0 million received for CY 2018 and $166.0 million received during CY 2019.

The funds were directed to the School group UAL but impacted the funding for the State/School group. The Executive Director also stated the $871.1 million in additional pension funding authorized by 2022 SB 421 was not included in the 2021 valuation, as the proceeds were received too late to be included but were included in the future cost projections. The Committee and the Executive Director discussed the funding projections presented and the anticipated investment returns for CY 2022.

Pension Obligation Bond Proceeds

The Executive Director also addressed pension obligation bonds, which serve as a form of arbitrage intended to reduce future employer contributions and improve the solvency of KPERS. The pension obligation bond proceeds also serve to improve the funded status of the Retirement System.

The State has issued three pension obligation bond series. The first was in 2004 for a total of $500.0 million, gross of fees (2004C bond issue); the second was issued in 2015 for $1.0 billion, net of fees (2015H bond issue); and the third in 2021 for a total of $500.0 million, net of fees (2021K bond issuance). 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). In 2021, the Legislature approved a $500.0 million bond issue, which was issued with a 30-year maturity and an interest cost of 2.65 percent. KPERS received $500.0 million in net proceeds. Annual debt service is approximately $24.0 million from the SGF.

Total returns. The average annualized total returns for the 2004C, 2015H, and 2021K bond issues, as of October 31, 2022, were 7.09 percent, 6.80 percent, and -7.78 percent, respectively. As of October 31, 2022, the three bond series had collectively exceeded interest cost by approximately $564.0 million (2004C, $408.0 million; 2015H, $216.0 million; 2021K, -$60.0 million). The Executive Director and the Committee discussed the proceeds, the SGF ending balance, and future bonding possibilities.

KPERS 3 Dividend Formula and Experience

The Planning and Research Officer, KPERS, provided information on the KPERS 3 dividend credit, established by 2012 law creating a cash balance plan. Differing from KPERS 1 and 2 plan design, the Cash Balance 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 credited under the Cash Balance plan are the guaranteed portion and the dividend. The guaranteed interest credit rate on the member and employer accounts is 4.0 percent and the discretionary dividend credit is a dividend design (KSA 74-49,306) equal to 75.0 percent of the five-year average net compound rate of return above 6.0 percent, as determined by the Board for the calendar year and the four preceding years. [*Note:* The Tier 3 plan serves as the primary retirement plan for new KPERS members since 2015. Some employees in corrections positions continue to be enrolled in KPERS 2.]

The Planning and Research Officer noted CY 2021 was the sixth year of the KPERS 3 plan. The dividend is reviewed by the Board each March, and over the first six years of KPERS 3, the formulaic interest dividend credit has applied four times. Increases occurred in CYs 2017 (1.1 percent), 2019 (0.825 percent), 2020 (2.475 percent), and 2021 (3.525 percent).

KPERS Board Actions—Change in Investment Return Assumption; Request for Alternative Investments Amendment

Investment return rate. The Executive Director noted the Legislature delegated the establishment of the investment rate of return assumption to the Board in 1998. The KPERS rate of return assumption had been consistent from 1986 to 2016 at 8.0 percent. In the December 31, 2016, valuation, the Board reduced the return assumption from 8.0 percent to 7.75 percent. Then, for the December 31, 2021, valuation, the Board reduced the return assumption rate from 7.75 percent to 7.00 percent.

The Executive Director stated the average investment return assumption in a survey of 131 public retirement plans was 6.99 percent. The trend has been to lower the rate-of-return assumptions, and that trend is expected to continue.

The estimated impact on the UAL, as noted in the earlier discussion of the December 31, 2021, actuarial valuation, would be an increase of $2.7 billion for the 0.75 percentage point reduction in the investment return assumption. The 0.75 percentage point return reduction also would reduce the funded ratio by an estimated 6.1 percent. The Executive Director stated that when the Board established the 7.0 percentage point investment rate assumption, it also made changes to the amortization method to pay for the adjustment.

Request for bill introduction, alternative investments cap. The Executive Director presented a request on behalf of the KPERS Board of Trustees relating to KPERS investments. The Board requests legislation that would permit it to set the percentage of alternative investments within the KPERS Trust Fund. Current law limits the sum of alternative investments to no more than 15 percent of the KPERS Trust Fund.

The Executive Director noted all other current limitations (*e.g.,* at least two qualified institutional buyers, any individual alternative investment cannot exceed more than 2.5 percent of the total alternative investments) would remain in place. Since the law became effective in 2012, the Board's strategic investment plan has increased the allocation to alternative investments to help increase returns while minimizing risk.

The Board is concerned that, as alternative investments approach the statutory cap, it will be limited in its ability to set future investments policies because of the cap. [*Note:* Draft language was included in the Board's request.]

KPERS Membership Trends and Retirement Experience

Deferred Retirement Option Program

The KPERS Planning and Research Officer provided information on the Deferred Retirement Option Program (DROP) for Kansas Police and Firemen's (KP&F) members in the Kansas Highway Patrol (KHP) and agents in the Kansas Bureau of Investigation (KBI).

Under the 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 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 7.00 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.

To date, the Planning and Research Officer stated, 67 members have enrolled in the DROP (61 KHP members and 6 KBI members). A total of 18 members have completed their DROP period and received their lump sum payments. In discussion with the Committee, the KPERS conferee indicated that the average DROP participant enrolled in the program was about one year younger than other members who elected to retire. The average time in DROP is 4.9 years, resulting in a KHP member in DROP staying longer on the job and retiring later. Discussion topics also included costs associated with DROP expansion.

Working after Retirement

The KPERS Planning and Research Officer reviewed recent retirement experience, noting that the average number of retirements had consistently been between 5,500 to 6,000 per fiscal year and had slowed down beginning in FY 2018 to about

5,200 in FY 2020. However, the number of retirements in FY 2021 and FY 2022 increased to nearly 6,000, which is where the rate is expected to remain over time.

The KPERS Planning and Research Officer said working-after-retirement requirements have been much easier to follow by both retirees and employers since the 2017 legislative changes, which provided a single set of rules for retirees and employers. During CY 2021, about 5,300 retirees were reported as returning to KPERS-covered work, with about 3,750 of those from schools. [*Note:* KPERS does not collect position-specific information, so it is not known how many of those positions are teachers.]

The requirements for KPERS-covered work positions (effective January 1, 2018) include:

- 180-day waiting period to return if younger than 62 years old and 60 days if 62 or older;
- No prearranged agreement to return;
- No earnings limitation on retirees returning to work; and
- Statutory KPERS contributions at the statutory rate for the first $25,000 in earnings and 30 percent for all earnings above $25,000.

KPERS Pension Administration System Modernization Project

The Executive Director outlined the purposes of the KPERS pension administration system, which provides the functionality needed to collect data and contributions from employers and to process and pay benefits. KPERS started using its present system in 2005. The existing system remains capable of providing these processes 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 Group, a consulting firm. The assessment helped clarify how the database could be restructured to provide better service to all customers. After an "Analysis and Retool" phase completed by the existing contractor, Sagitec, KPERS decided to develop a comprehensive request for proposal for a new system.

The Executive Director said that the work completed by Sagitec was focused on the existing system, which will continue to be used for the next four years. The current budget for project expenditures in FY 2023 is $9.2 million from the KPERS Trust Fund for temporary positions, data cleaning, and new software. The estimate for FY 2023 is $9.2 million and is anticipated to be approximately $9.0 million for FY 2024.

Investment Performance and Topics

Investment performance. The KPERS Chief Investment Officer (CIO) provided an overview of the KPERS Trust fund performance for FY 2022: a negative return of 4.7 percent although the fund outperformed the policy index, or asset class benchmark, by 3.8 percent.

He also reported on the fund returns for the previous 3, 5, 10, 20, and 25 years with a low return of 7.1 percent for the 3-year average to a high of 8.5 percent for the 20-year average. The fund also outperformed the policy index or asset class benchmark by a range of 0.5 percent to 1.7 percent for each of the above time periods.

Exposure to Hong Kong and China. The CIO reported on the market value of total assets in Hong Kong and China. Publicly traded equity investments in Hong Kong represented 0.8 percent of total assets with a market value of $187.4 million. Investments in China were 1.45 percent of total assets. Publicly traded equity investments were 1.28 percent of total assets, or $299.2 million, with privately traded equity investments representing 0.17 percent of total assets or $41.0 million. There is no exposure to debt issued by Hong Kong or China.

He reported the Retirement System's China exposure in the international equity portfolio is in line with the benchmark weighting.

Environmental, social, and governance investments. The CIO stated that Environmental, Social and Governance (ESG) investments seek to advance certain investors and investment managers' social initiatives in areas such as climate change, workers' rights, diversity, and equity. These are usually in equity-related investment mandates. He indicated equity managers impact investor decisions to advance ESG goals:

- By actively buying or selling specific securities within an investor's portfolio;
- Through corporate policies outside of those expressed through an investor's portfolio; and
- Through an investor's delegation of proxy voting authority (KPERS delegated this duty to each equity manager that has fiduciary responsibilities and follows KPERS investment strategies and statutes).

He identified two items in the Statements of Investment Policy, Objective and Guidelines concerning Socially/Politically Responsible Investment Policy. The first was that the KPERS Board of Trustees' first responsibility as a fiduciary is to prudently invest the assets of the system solely for the benefit of members and beneficiaries.

The second was that the investments should provide the highest expected return commensurate with the lowest expected risk and are appropriately diversified. The third was that criteria other than these will not override the above.

He also stated that KSA 74-4921 includes language that states that no moneys in the fund shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives.

The CIO stated KPERS does not invest in any ESG-focused mandates, nor does the system impose ESG considerations on any of its managers.

Recent KPERS Law and Legislation; Performance Audit Study Topics Discussion

Recent KPERS laws and legislation. A Senior Assistant Revisor (revisor), Office of Revisor of Statutes, reviewed three bills that were enacted into law in 2022. HB 2481 authorized service credit purchase for certain in-state nonfederal government employment in the KP&F. SB 450, among other things, eliminated the requirement of 80 percent of proceeds received from sale of surplus real estate be deposited into the Kansas Public Employees Retirement Fund. SB 421 transferred a total of $1.125 million to the KPERS Trust Fund in four installments.

The first transfer of $553,866,022 was made in May 2022, upon publication of the bill. Of that amount, the first $253,866,022 was to repay in full the delayed KPERS payments in FY 2017 and FY 2019. The second transfer of $300.0 million was made in June 2022, the third transfer of $146.1 million was made in August 2022, and the final transfer of $125.0 million was made in December 2022. He also identified five bills that had legislative action but did not pass and six other bills introduced that had no legislative action.

Performance audit topics. The Committee considered and provided input to the Legislative Post Audit Committee on selection of KPERS-related performance audit topics pursuant to KSA 46-1136. The KPERS Executive Director suggested three performance audit topics for the Committee to consider: working after retirement, KP&F coverage for KPERS corrections members, and KPERS cost-of-living adjustments (COLAs).

During discussion, the Committee agreed to recommend these possible topics to the Legislative Post Audit Committee with the working-after-retirement topic as the lowest priority of the three.

Conclusions and Recommendations

The Committee submits the following conclusions and recommendations:

- **Joint select committee.** The Committee recommends that legislative leadership establish a joint Select Committee to evaluate KPERS Tier 3. The Committee recommends the Select Committee review the performance of Tier 3, determine whether the cash balance plan is fulfilling its intended purpose, and consider whether any adjustments need to be made to provide the equity as intended and the overall benefit value.

- **Extraordinary KPERS payment.** The Committee recommends the appropriate standing committees review using some of the projected SGF surplus ending balance to make additional contributions toward the reduction of KPERS unfunded actuarial liability.

- **Legislative Post Audit performance audit topics.** The Committee proposes the topics as recommended by KPERS in its update: working after retirement, KP&F coverage for KPERS corrections members, and KPERS COLAs. The Committee states the working-after-retirement topic is the lowest priority of the three suggested performance audit topics.

- **Alternate investment allocation cap removal (bill request).** The Committee will introduce a bill to remove the statutory cap of 15.0 percent and provide flexibility for the KPERS Board of Trustees to establish a more relevant allocation cap on its alternate investments.

- **KPERS COLAs (bill request).** The Committee recommends reintroduction of the provisions of 2022 HB 2612 that provide a self-funded COLA option for new retirees. This option is similar to the current option provided for Tier 3 members.