Report of the Joint Committee on Pensions, Investments, and Benefits to the 2016 Kansas Legislature

CHAIRPERSON: Representative Steven Johnson

VICE-CHAIRPERSON: Senator Jeff King

OTHER MEMBERS: Senators Anthony Hensley, Mitch Holmes, Laura Kelly, and Ty Masterson; Representatives John Alcala, John Edmonds, Daniel Hawkins, Jerry Henry, Charles Macheers, Gene Suellentrop, and Ed Trimmer

CHARGE

The Joint Committee on Pensions, Investments, and Benefits is charged to study the following issues and topics during the 2015 Interim:

- Legislation enacted during the 2015 Legislative Session affecting the Kansas Public Employee Retirement System (KPERS), in particular:
  - Senate Sub. for HB 2095, which revised working-after-retirement provisions and created a pilot Deferred Retirement Option Program for members of the Kansas Highway Patrol; and
  - SB 228, which authorizes $1.0 billion in bonds to be issued for KPERS' unfunded actuarial liability;
- The overall funding ratio for the Retirement System;
- Various reports statutorily required to be submitted by KPERS and other state agencies to the Joint Committee; and
- To fulfill the Joint Committee's duties and responsibilities, as provided by KSA 2015 Supp. 46-2201, to monitor, review, and make recommendations regarding KPERS.

The working-after-retirement legislation mentioned above also authorizes the Joint Committee to grant employment extensions if certain conditions are met. Procedures should be established by the Joint Committee prior to considering requests.

December 2015

Joint Committee on Pensions, Investments, and Benefits

Report

Conclusions and Recommendations

The Joint Committee expresses its gratitude to the task force of superintendents for their effort in evaluating the new working-after-retirement provisions. The Joint Committee should finalize guidelines during the 2016 Legislative Interim.

When considering future modifications of working-after-retirement provisions, the Joint Committee suggests the Legislature consider the addition of a 30 percent surcharge to address cost concerns and provide needed flexibility to meet staffing needs. Pertinent Internal Revenue Service requirements should be examined during those discussions.

Finally, the Joint Committee notes its statutory responsibility to study in 2016 the issue of whether the $25,000 compensation limit placed on retirees who return to work should be adjusted.

Proposed Legislation: None.

Background

The Joint Committee on Pensions, Investments and Benefits was created in 1992 and is directed by KSA 46-2201 to:

- Monitor, review, and make recommendations relative to investment policies and objectives formulated by the Kansas Public Employees Retirement System (KPERS) Board of Trustees;
- 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 of Trustees.

The Joint Committee may introduce legislation it determines to be necessary.

Committee Activities

The Joint Committee met November 4, 2015, to review KPERS long-term funding, the issuance of pension obligation bonds that had been authorized by the 2015 Legislature, a KPERS performance audit, newly enacted provisions regarding working after retirement, and deferred compensation as it relates to final average salary calculations. The Joint Committee also received reports and information submitted by KPERS.

Review of KPERS Long-Term Funding

The Joint Committee reviewed the 2014 actuarial valuation, which is a snapshot of the financial condition of the Retirement System as of December 31, 2014. The actuarial valuation, which is different from the market valuation, was estimated to be $15.662 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 $660 million in deferred gains that could be realized in the outlying years. Due in large part to investment gains over the past three years, the funding status has improved for all membership groups (KPERS state, school, and local groups; Kansas Police and Firemen's Retirement System; and Judges' Retirement System). The Unfunded Actuarial Liability (UAL) for the entire system decreased in 2014 by $298 million, leaving $9.468 billion remaining to be funded. The funded ratio increased from 59.5 percent in 2013 to 62.3 percent in 2014. Legislative reforms enacted in 2012, including increased employer and employee contributions, will continue to improve funding. Assuming all actuarial assumptions are met in the future, KPERS will be fully funded at the end of the amortization period in calendar year 2031. The valuation does not include the proceeds of the recently issued pension obligation bonds, which will be included in the 2015 actuarial valuation report.

Pension Obligation Bonds

Staff from the Kansas Development Finance Authority (KDFA) presented information to the Joint Committee regarding the issuance of the Series 2015H pension obligation bonds. KPERS received the proceeds of the bonds on August 20.

The Executive Director of KPERS said the bond proceeds were distributed to asset managers within 24 hours of receipt and spread across KPERS' current asset allocation arrangement. Future debt service is the State's responsibility through the Department of Administration and not through KPERS.

KPERS Performance Audit Report

Staff from Legislative Post Audit (LPA) briefed the Joint Committee on the findings of the Performance Audit Report *KPERS - Evaluating Controls to Detect Fraud and Abuse*. The audit report found KPERS had most of the controls needed to help ensure it collects accurate retirement contributions and distributes its controls to detect and prevent fraud and abuse. LPA identified one significant control weakness: the suspension of field audits for almost two years. KPERS reports it has since resumed that function, which helps ensure KPERS receives accurate employer contributions. LPA identified options that would help KPERS verify the ongoing eligibility of disability recipients. Other identified issues were isolated in nature and have been since corrected.

The Executive Director of KPERS presented an overview of actions taken to address shortcomings identified in the audit. KPERS has entered into discussions with the Kansas Departments of Revenue and Labor to provide data that can be used to discern whether an employee is a member of the Retirement System.

2015 Senate Sub. for HB 2095; Working After Retirement

Staff from the Office of Revisor of Statutes provided an overview of the provisions of 2015 Senate Sub. for HB 2095, regarding working after retirement.

The Executive Director of KPERS explained the impact of the enacted legislation on current KPERS members who are working after retirement. Under the current provisions no employer contributions are paid on the first $20,000 earned; under the new provisions employer contributions will be paid on the first dollar paid to employed retirees.

The Joint Committee received a memorandum from the Department of Education that listed the hard-to-fill teacher positions as certified by the State Board of Education.

Representatives from a task force of school administrators from across the state, which was formed to evaluate the recently passed working-after-retirement legislation, applied the new provisions to various scenarios. While initially skeptical of the applicability, the task force recognized the effort taken to address many of the circumstances that can arise when hiring a retired employee. In employment situations involving emergency or hardship circumstances, the conferees expressed concern that using a legislative hearing process may not be practical. The conferees recommended an assurance protocol be filed with KPERS, which would be signed by the school's superintendent and board president, documenting the steps taken by a school district to fill a position.

The conferees requested the Joint Committee members consider an additional actuarial fee, as established by KPERS, which would be paid by the participating employer, the working retiree, or both.

Deferred Compensation and Final Average Salary

The Executive Director of KPERS provided information on current deferred compensation and final average salary calculations. Annual pension benefits for most retirees are based on the formula: final average salary multiplied by years of service, multiplied by a percentage multiplier. The final average salary variable—depending upon the member's plan, tier, and membership date—is based on an average of three to five years of "compensation" or "salary," as those terms are defined in statute, which include definitions for all salary and wages payable to a member for personal services performed for a participating employer. Both definitions specifically include deferred compensation derived from savings plans authorized by sections 403(b) and 457 of the Internal Revenue Code. There are two types of 457 plans, a 457(b) plan, which is offered by governmental employers to most, if not all, state and local government employees, and a 457(f) plan, which is used by employers to retain certain employees. A 457(f) plan is usually limited to particular employees; the employer establishes and funds the plan in a contract with the employee. The employee does not receive any income until the end of the contract period.

KPERS has found the use of 457(f) plans to be extremely rare; out of approximately 90,000 retirements in the past 20 years, there has been three instances where 457(f) benefits were included in the final average salary. Current retirement law caps the effect of 457(f) benefits on final average salary by excluding the salary amount which is greater than 15 percent or 7.5 percent for Tier 1 or Tier 2 members, respectively. A 457(f) plan would have a smaller impact on the KPERS 3 Cash Balance Plan because those benefits are calculated on an account basis rather than on final average salary. KPERS 3 accounts reflect compensation earned throughout a member's career, not the highest three or five years. Contributions to a 457(f) plan which is paid at or near retirement would earn interest for a limited period of time. The Internal Revenue Service (IRS) annually sets a contribution limit based on annual earnings and membership date. Kansas has adopted the IRS limitation levels by statute.

Moneys in 457(f) plans could be limited when calculating final average salaries—so long as the provision applied prospectively.

Submission of KPERS Reports and Other Requested Information

The Executive Director of KPERS submitted reports on Alternative Investment Policy, including the implications of the legislative changes made to KPERS in 2012, and Sudan Divestment.

Conclusions and Recommendations

The Joint Committee expresses its gratitude to the task force of superintendents for their effort in evaluating the new working-after-retirement provisions and for making suggestions to improve the State's retirement laws. The Joint Committee should finalize guidelines during the 2016 Legislative Interim. This should give participating employers and retired employees time to understand the new policy.

When considering future modifications of working-after-retirement provisions, the Joint Committee suggests the Legislature consider the addition of a 30 percent surcharge to address cost concerns and provide needed flexibility to meet staffing needs. The Legislature and KPERS should examine pertinent IRS requirements during those discussions.

Finally, the Joint Committee notes its statutory responsibility (KSA 2015 Supp. 74-4914) to study in 2016 the issue of whether the $25,000 compensation limit placed on retirees who return to work should be adjusted. Adjustment to the limit must consider inflation and data on member retirement benefits and active employee compensation.