Report of the Joint Committee on Pensions, Investments and Benefits to the 2019 Kansas Legislature

CHAIRPERSON: Senator Jeff Longbine

VICE-CHAIRPERSON: Representative Steven Johnson

OTHER MEMBERS: Senators Larry Alley, Anthony Hensley, 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 2018 Legislative Session affecting the Kansas Public Employees Retirement System (KPERS or Retirement System);
- 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;
- Two firefighter-related topics from the 2017-2018 Biennium—the Retirement System cap for the Kansas Police and Firemen's Retirement System and tools to address cancer in death and disability benefits (*e.g.*, the definition of "service connected"); and
- In order to fulfill the Committee's duties and responsibilities, as provided by KSA 2018 Supp. 46-2201, monitor, review, and make recommendations regarding the Retirement System.

December 2018

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Joint Committee on Pensions, Investments and Benefits

Annual Report

Conclusions and Recommendations

The Committee encourages the standing committees of the Senate and House that are responsible for retirement policy to consider introducing legislation increasing the Kansas Police and Firemen's Retirement System (KP&F) retirement cap.

The Committee notes the Legislature must contribute an estimated $631.0 million in FY 2020, at the minimum, in order to prevent the unfunded actuarial liability (UAL) from increasing. The Committee finds it is preferable to contribute at least $50.0 million more than that amount if the State intends to meet the actuarial required contribution rate in FY 2021.

The Committee commends the Kansas Public Employees Retirement System (KPERS or Retirement System) Board of Trustees, staff, and wealth managers for implementing prudent investment strategies that have mitigated risk while seeking out returns.

The Committee recommends the Legislature review the law regarding the sale of surplus public property and the amounts credited to KPERS.

The Committee recommends the Legislature consider repealing the sunset on the pilot Deferred Retirement Option Program utilized by the Kansas Highway Patrol. There may be merit to broaden the program to include other law enforcement agencies; however, those agencies must demonstrate a need, explaining how the program would be a viable means to increase retention.

Proposed Legislation: A bill to redefine the term "service connected," as that term is used in the death and disability provisions of the KP&F Plan.

Background

The Joint Committee on Pensions, Investments and Benefits, created in 1992, is authorized by KSA 2018 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 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 KPERS Board; and
- Introduce legislation it determines to be necessary.

On June 27, 2018, the Legislative Coordinating Council (LCC) charged the Committee to consider two firefighter-related topics from the 2017-2018 Biennium pertaining to the cap on retirement benefits and certain death and disability benefits.

Committee Activities

The Committee met on October 29, 2018, to review KPERS long-term funding, the performance of pension obligation bonds, newly enacted legislation, investment performance, a pilot program, and the LCC charge. The Committee recommended legislation be introduced.

Review of KPERS Long-term Funding

The Committee reviewed the latest actuarial valuation, which is a snapshot of the financial condition of the Retirement System as of December 31, 2017. The actuarial value was estimated to be $19.247 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 deferred investment gains or losses will flow through valuations over the subsequent four years. There is an estimated $338.0 million in net deferred gains to be realized in the outlying years. A year ago, net deferred loss was $566.0 million.

The funding status has improved for four of the five membership groups: the KPERS state, school, and local government groups and the Judges’ Retirement System. The funded ratio for the Kansas Police and Firemen’s Retirement System (KP&F) has decreased. The Retirement System’s overall funded ratio increased from 66.8 percent in 2016 to 68.4 percent in 2017. The unfunded actuarial liability (UAL) for the entire Retirement System decreased in 2017 by $154.2 million, leaving $8.907 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 2032. For KPERS funding to remain at a steady state, state-school employer contributions in FY 2020 will need to be $631.0 million, which includes $95.2 million for the normal employer cost rate, $510.0 million for the UAL, and $25.8 million for the deferred school contributions of fiscal year (FY) 2017 and FY 2019.

Bond Proceeds; Investment Performance

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 $500.0 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.

The average annualized total returns for the 2004C and 2015H bond issues, as of June 30, 2018, are 7.38 percent and 7.95 percent, respectively. The two bond series have added approximately $387.0 million to KPERS (2004C, $287.0 million; 2015H, $100.0 million).

Overview of 2017 Legislation Enacted; Implementation of New Provisions

Staff from the Office of Revisor of Statutes (Revisor) provided an overview of 2018 SB 260, which transferred the procurement responsibility of annual financial compliance audits from the Legislative Division of Post Audit to the Board, and 2018 HB 2444, which repealed statutes pertaining to divestment from Sudan and related reporting requirements. Staff also reminded the Committee of new working-after-retirement provisions that were previously enacted and took effect on January 1, 2018.

Investment Performance

At the end of FY 2018, the net asset value of the portfolio exceeded $19.4 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 8.7 percent. This is 70 basis points greater than the KPERS' benchmark. The top three performing asset classes were alternative investments, domestic equity, and real estate, generating returns of 17.1 percent, 14.9 percent, and 11.6 percent, respectively. For the trailing returns of the past 3-, 5-, 10-, and 25-year periods, the portfolio has surpassed its respective benchmarks.

KPERS' Chief Investment Officer observed there has been robust domestic growth, especially in corporate earnings. Risk factors for the future include high equity valuations, fading effects from the recent federal tax cuts, inflationary pressures, rising interest rates, international trade, and geo-politics. KPERS personnel recommended maintaining the current disciplined approach to wealth management, reducing risk while seeking increased returns where evident.

KP&F Benefit Cap; Death and Disability Definition

Revisor staff briefed the Committee on legislation that had been introduced during the 2017-2018 Legislative Biennium. Two bills (2017 SB 241 and 2018 HB 2720) would have increased the retirement cap for KP&F members, which is currently 90.0 percent of "final average salary," as that term is defined by law. Two other bills (2017 SB 242 and 2018 HB 2719) would have revised the definition of "service connected," as that term is used in KP&F death and disability benefits.

KPERS personnel presented a historical view on the KP&F retirement cap in 2013, from 80.00 percent to 90.00 percent, and on the employee contribution increase, from 7.00 percent for the first 32 years of service and 2.00 percent thereafter to 7.15 percent for all years of service. The Judges' Retirement System, it was noted, also has a maximum benefit cap, which is currently 70.0 percent of final average salary.

With regard to the disability definition, KPERS personnel found the term "blood-borne illnesses" was used in other states instead of specifically stating hepatitis C. Blood-borne illnesses would include all strains of hepatitis as well as HIV and other illnesses.

A representative from the Kansas State Council of Fire Fighters appeared in support of both topics, saying the legislation previously introduced was based on Colorado law. He reviewed a study conducted by the National Institute for Occupational Safety and Health, from 2010 to 2015, for which nearly 30,000 firefighters were followed. The study found higher rates of certain types of cancer than in the general population. Studies have concluded firefighters' health is affected by the absorption of the different chemicals and toxins into the skin that are present in hazardous environments. He stated there is no way to completely keep people who work in those environments safe from exposure.

With regard to the limit on benefits, the conferee stated when the 90.0 percent cap was instituted, no one conceived it would be met, but today several older employees have exceeded the cap. The conferee proposed the language be changed to allow for 100.0 percent benefit accrual or eliminate the language pertaining to the cap altogether.

Deferred Retirement Option Program (DROP)

The Superintendent of the Kansas Highway Patrol (KHP) updated the Committee on the pilot program, which was authorized in 2015 and will sunset on January 1, 2020. Upon attaining normal retirement age, troopers, examiners, or officers of the KHP have the option of participating in the DROP plan for a minimum of three years and no more than five years. This is a one-time, irrevocable choice. Participation in the DROP plan does not guarantee continued employment. After electing to participate, a member's monthly retirement benefit, as determined by law, is deposited into the member's DROP account for the duration of the time period. The DROP account accrues interest on an annual basis, ranging from 0.0 percent to 3.0 percent, subject to certain investment rate-of-return requirements. During the member's DROP period, the member remains in active service. Employer and employee contributions continue to be made to KP&F, but the member does not earn any additional service credit after the effective date of the DROP election. If a member fails to subsequently participate in the DROP plan for a minimum of three years, all of the member's interest credits are forfeited. However, a disabled member does not forfeit interest earned. At the end of the time period, a member is entitled to a distribution from the DROP account, which either may be rolled over into an eligible retirement plan or taken out as a lump-sum distribution.

To date, 13 eligible members of the KHP have entered DROP, which went into effect in 2016, around the same time the Career Progression Plan for troopers had started. A recent survey by the KHP indicated 162 troopers intend to enter DROP in the next 10 years, representing more than a third of the trooper workforce. The Committee was urged to permanently establish DROP for the KHP during the 2019 Legislative Session.

The Committee acknowledged receipt of written testimony from the Director of the Kansas Bureau of Investigation, who expressed interest in continuing DROP and expanding it to include that agency.

Conclusions and Recommendations

In response to the LCC charge, the Committee recommends legislation be introduced redefining the term "service connected," as that term is used in the death and disability provisions of the KP&F Plan. Based upon recent studies, the term should reflect specific types of cancers and include blood-borne illnesses.

Also in response to the LCC charge, the Committee encourages the standing committees of the Senate and House that are responsible for retirement policy to consider introducing legislation increasing the KP&F retirement cap. The various stakeholders and interested parties should consult with each other to ensure the legislation does not contain any unintended, adverse consequences.

For the first time in 24 years, the statutory employer contribution rate for the State-School Group will equal the actuarial required rate of contribution (ARC) in FY 2021, 14.23 percent. This reflects, in part, the Legislature's dedication to improve the long-term solvency of the Retirement System. In FY 2018, the State contributed a record $541.0 million. In the near future, the Legislature must contribute an estimated $631.0 million in FY 2020, at minimum, in order to prevent the UAL from increasing. It is preferential to contribute at least $50.0 million more than that amount if the State intends to meet the ARC rate in FY 2021.

The Committee notes KPERS was at one time one of the least funded public pension systems in the country; now Kansas has moved to the middle third of state rankings. Contributions alone cannot explain the improvements that have taken place. The Committee commends the KPERS Board, staff, and wealth managers for implementing prudent investment strategies that have mitigated risk while seeking out returns.

The Committee recommends the Legislature review the law regarding the sale of surplus public property to discern which property has been sold, the means of sale, and the amounts credited to KPERS.

The Committee recommends the Legislature consider repealing the sunset on the pilot DROP Program. If there are committee deliberations, the Committee requests KPERS to provide information on how the program has performed, including a cost-benefit analysis. There may be merit to broaden the program to include other law enforcement agencies; however, those agencies must demonstrate a need, explaining how the program would be a viable means to increase retention.