Report of the Joint Committee on Pensions, Investments and Benefits to the 2020 Kansas Legislature

CHAIRPERSON: Representative Steven Johnson

VICE-CHAIRPERSON: Senator Jeff Longbine

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, and Sean Tarwater

CHARGE

To fulfill the Joint Committee's duties and responsibilities, as provided by KSA 2018 Supp. 46-2201, the Joint Committee will monitor, review, and make recommendations regarding the Kansas Public Employees Retirement System (KPERS or Retirement System).

January 2020

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Joint Committee on Pensions, Investments and Benefits

Annual Report

Conclusions and Recommendations

The Joint Committee on Pensions, Investments and Benefits recommends the Legislative Post Audit Committee consider three studies: performance of the Deferred Retirement Option Program (DROP), expenses related to net investment performance, and contract management. With regard to the DROP, the Joint Committee further recommends no new legislation pertaining to the program be introduced or considered until the legislative session immediately prior to the program's sunset date of January 1, 2025, which should allow time for a complete evaluation of the program.

The Joint Committee recommends, either now or at the appropriate time when enough data has been collected, Kansas Public Employees Retirement System (KPERS) staff provide information to the Legislature on the trends in public retirement and working after retirement to discern the extent to which KPERS members remain active employees for greater periods of time.

The Joint Committee identified nine past interim committee reports that discuss the transfer of employees into different retirement plans. In six of the nine reports, the interim committees either did not take an action or recommended further study. While three reports recommended adding groups to the Kansas Police and Firemen's Retirement System (KP&F), only in one instance, found in 1981, did the Special Committee on Pensions and Investments introduce legislation. A few interim committee reports observed stress and a job situation should not be across-the-board determinations for movement from KPERS to KP&F. The Joint Committee recommends further discussion and study may be necessary regarding state and local corrections, Kansas Department of Parks, Wildlife and Tourism (KDWPT) and similar groups, suggesting within this report means to study the topic and guidelines for future discussions.

The Joint Committee recommends KPERS staff study the legal definition of alternative investments and reevaluate the extent to which other investments should be classified as alternative investments.

Finally, the Joint Committee recommends those standing committees of the House and Senate that are assigned pension legislation during the 2020 Session hold hearings on the KPERS Board of Trustees' newly approved rate of return and the assumptions behind it.

Proposed Legislation: None

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 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 Joint Committee met November 4, 2019, to review KPERS long-term funding, the investment performances of pension obligation bonds and the portfolio of the Retirement System, the Deferred Retirement Option Program (DROP), and newly enacted legislation. The Joint Committee recommended topics for the consideration of the Legislative Post Audit Committee and discussed the pension benefits for Correctional KPERS and similar groups of employees and law enforcement personnel. The Joint Committee also received a briefing on the Board's triennial experience study, which is used to establish the assumed rate of return for the subsequent three years.

Review of KPERS Long-term Funding

The Joint Committee reviewed the latest actuarial valuation, which is a snapshot of the financial condition of the Retirement System as of December 31, 2018. The actuarial value was estimated to be $19.898 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 $1.2 billion in net deferred loss to be realized in the outlying years. A year ago, there was a net deferred gain of $388.0 million.

The Retirement System's overall funded ratio for 2018 remains unchanged from 2017, at 68.4 percent. The standards for public pension plans suggest a retirement system should be funded between 80.0 percent to 100.0 percent of future liabilities owed. The unfunded actuarial liability (UAL) for the Retirement System, however, increased in 2018 by $290.0 million, leaving $9.2 billion to be funded. If current assumptions are met in the future, KPERS should be fully funded at the end of 2040. For KPERS funding to remain at a steady state, State-School Group employer contributions in FY 2020 will need to be $641.0 million, which includes $91.6 million for the normal employer cost rate, $523.6 million for the UAL, and $25.8 million for the deferred school contributions of fiscal year (FY) 2017 and FY 2019.

Investment Performance of 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 $500.0 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 (SGF).

The average annualized total returns for the 2004C and 2015H bond issues, as of September 30, 2018, are 7.28 percent and 7.30 percent, respectively. The two series of bonds have added approximately $446.0 million to KPERS (2004C, $318.0 million; 2015H, $128.0 million).

Investment Performance of KPERS Portfolio

At the end of FY 2019, the net asset market value of the portfolio was more than $20.220 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 6.7 percent, 20 basis points greater than KPERS' benchmark. The top three performing asset classes were alternative investments, domestic equity, and fixed income, generating returns of 13.8 percent, 9.0 percent, and 8.2 percent, respectively. For the trailing returns of the past 3-, 5-, 10-, and 25-year periods, the portfolio has surpassed its respective benchmarks.

The Chief Investment Officer (CIO), KPERS, observed national and foreign monetary policies have increased market values. Risk factors for the future include weakening economic growth in the United States, less growth in domestic corporate earnings, international trade, geopolitics, and the possibility of negative interest rates. KPERS personnel recommended maintaining the current disciplined approach to wealth management, reducing risk while seeking increased returns where evident. The CIO noted the yield-driven portfolio is a risk class and not an asset class, noting most assets are invested in high-yield income with exposure to bank loans, real estate trust, and small yield investments.

Deferred Retirement Option Program

KPERS staff provided information on the DROP for Kansas Police and Firemen's Retirement System (KP&F) members in the Kansas Highway Patrol (KHP) and the Kansas Bureau of Investigation (KBI). In the program, a member may initiate retirement benefits, but defers the receipt of the benefits for a three- to five-year period. The member does not earn additional service credits, but continues to contribute 7.15 percent of compensation into the DROP. KHP 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. Currently, there are 600 KP&F members eligible to participate in the DROP, approximately 9.0 percent of KP&F members. KPERS staff cautioned if the DROP was extended to additional employers, the Retirement System would need to make information technology updates and hire additional staff for administration.

A representative of the KBI stated the agency requested last year to be added to the DROP because of staffing shortages for the past five years. In 2017, the KBI implemented a salary progression matrix for classified personnel of special agents who were operational and working in the field. The group maxes out at 19 years of service, and afterward they do not get additional compensation benefits for staying with the agency. Three agents have joined the DROP since July 1, 2019, when the agency started participation in the program. From the KBI's perspective, she noted, the DROP will be beneficial for the employees and the agency.

Overview of 2019 Legislation Enacted

Staff from the Office of Revisor of Statutes (Revisor) provided an overview of KPERS legislation enacted in 2019, stating HB 2031:

- Added "contraction of a bloodborne pathogen" to the definition of "service connected" in the KP&F plan;
- Amended the powers and duties of the Board;
- Established a two-year KPERS waiting period for certain membership;
- Created a working-after-retirement exemption for certain KPERS retirees;
- Exempted individuals who retired on or after July 1, 2016, and before July 1, 2019, from working-after-retirement penalties;
- Added language allowing the Executive Director of KPERS to waive working-after-retirement penalties beginning on and after July 1, 2019; and
- Added KBI agents to the eligible membership in the DROP and extended the sunset of the program to January 1, 2025.

Revisor staff said 2019 SB 9 transferred $115.0 million from the SGF to KPERS during FY 2019. House Sub for SB 25 (Section 55(b)) repealed the FY 2019 transfer of up to $56.0 million, which would have been contingent upon actual revenues exceeding the most recent joint estimate. However, Section 56(e) transferred an unconditional $51.0 million from the SGF to KPERS in FY 2020.

Communication to Legislative Post Audit Committee

The Legislative Post Auditor explained a performance audit of KPERS is required by state law at least once every three years. The Legislative Post Audit Committee will be asked in April 2020 to approve an audit of the Retirement System. By law, the Joint Committee may communicate its audit suggestions to the Legislative Post Audit Committee.

Correctional KPERS and KP&F

Kansas Legislative Research Department staff briefed the Joint Committee on the various interim studies over the decades that have discussed transferring personnel, whether state or local government employees, into either Correctional KPERS or into KP&F.

Revisor staff provided an overview of bills introduced during the 2019 Session involving changes to KP&F membership and the current status of each bill. HB 2165 would require adult corrections officers, juvenile correctional officers, and security officers to move from the KPERS Correctional Groups to KP&F. The bill also would include support staff within any correctional institution or juvenile correctional facility that have regular contact with inmates or juvenile offenders. KP&F benefits would be for service commencing on and after January 1, 2020. Benefits earned prior to that date would be calculated under KPERS statutes. The bill was referred to the House Committee on Financial Institutions and Pensions, which held a hearing on February 25, 2019. The Committee has not acted on the bill and remains in the Committee for possible action during the 2020 Session.

HB 2139 and SB 121 would permit detention deputies, corrections officers, detention officers, or jailers employed by local units of government to be covered by KP&F. HB 2139 was referred to the House Committee on Financial Institutions and Pensions, which held a hearing February 20, 2019. The bill remains in that Committee for possible action during the 2020 Session. SB 121 was referred to the Senate Committee on Financial Institutions and Insurance, which held a hearing on February 19, 2019; that Committee recommended the bill be passed as amended by making affiliation with KP&F be for future service only. The Senate has taken no action.

HB 2099 would have authorized the Kansas Department of Wildlife, Parks and Tourism (KDWPT) to become an eligible employer with KP&F commencing on July 1, 2019, for those certified, full-time officers and employees who have successfully completed law enforcement course work approved by the Kansas Law Enforcement Training Center (KLETC). Starting July 1, 2020, members would be required to make the KP&F employee contribution of 7.15 percent of compensation. The bill was referred to the House Committee on Financial Institutions and Pensions, which held a hearing February 6, 2019. The Committee recommended the bill be passed on February 12, 2019. On February 28, 2019, the bill was removed from the House Calendar pursuant to House Rule 1507.

KPERS staff gave an overview of KP&F, which consists of approximately 5.0 percent (7,695 members) of the Retirement System's total active membership (154,055 members), and the associated employer and employee contribution rates. If KPERS correctional officers contribute to Social Security, they will remain in the federal program even though the members move to KP&F. This also applies to the employers that make Social Security contributions. HB 2099 would have an estimated increase of $600,000, including a $700,000 increase for KDWPT and a decrease of $100,000 spread across all other state KP&F employers. Regarding HB 2139 and SB 121, it is not possible to estimate the impact of those bills without more information. The cost estimate for HB 2165 would be approximately $5.2 million. This would include a $6.1 million cost increase for the Kansas Department of Corrections (KDOC), but a decrease of $900,000 in savings spread across all other KP&F employers.

KPERS staff said when the number of participating employers decreases, the remaining unfunded liability must be spread over the smaller group. The vesting difference is 11 years of service for KP&F versus 9 years for Correctional KPERS. If an employee goes from one plan to another with nine years of service in Correctional KPERS, the employee would have to work six more years in KP&F to be vested. If the employee quits or retires early, that person would get regular KPERS benefits plus the employee's contributions made to KP&F, with interest, with no service benefit.

The Secretary of Wildlife, Parks and Tourism and representatives from KDOC and the Kansas Sheriffs' Association spoke in favor of increasing the membership of KP&F so as to match the service provided by various public employees and law enforcement officers and to increase retention.

KPERS Board, Experience Study, and Planning Assumptions

KPERS staff briefed the Joint Committee on the triennial experience study which, by law, covers actuarial assumptions and experience and makes preliminary recommendations to the Board regarding the assumed rate of return for the future three years. Assumptions have a significant impact on the calculation of liabilities and contribution rates. Accurate assumptions are important to ensure generational equity. The study compares the actual experience of the past three years with the current assumptions. The Board is responsible for the selection of actuarial assumptions that are used for budgeting and planning purposes. Preliminary recommendations for actuarial methods and demographic assumptions will be presented at the Board's November 2019 and January 2020 meetings for consideration and approval.

Conclusions and Recommendations

The Joint Committee recommends the Legislative Post Audit Committee consider studies pertaining to the following topics:

- The DROP's performance and its cost to KHP and other employers in KP&F. The study should focus on the extent to which the policy has kept troopers on the road, the rates of KHP employees' participation in the program, and who has benefited from it;
  - The Joint Committee further recommends to the Legislature no new legislation regarding the DROP be introduced or considered until the legislative session immediately prior to the program's sunset date of January 1, 2025, which should allow time for a complete evaluation;
- The expenses related to net investment performance. While KPERS' investment and management costs appear low, the extent to which all investment-related expenses are included should be determined and discerned whether they are reasonable; and
- The management of contracts, including contracts for actuary and investments services, to discern whether there is sufficient control and oversight since in recent years KPERS has been granted greater autonomy and administrative discretion in its procurement of contractual services than most state agencies.

The Joint Committee recommends, either now or at the appropriate time when enough data has been collected, KPERS staff provide information to the Legislature on the trends in public retirement and reemployment in Kansas to discern the extent to which KPERS members remain active employees for greater periods of time. Substantial changes were made to working-after-retirement rules during the 2017 Session.

Based upon legislative interim records starting in the 1930s, the Joint Committee identified nine past interim committee reports that discuss the transfer of employees into different retirement plans. In six of the nine reports, the interim committees either did not take an action or recommended further study. While three reports recommended adding groups to KP&F, only in one instance, found in 1981, did the Special Committee on Pensions and Investments introduce legislation to allow employees who were instructional staff at the KLETC, personnel trainers with fire service programs, or campuses' patrol officers into KP&F. When comparing the various reports, the definition of law enforcement officer or firefighter seemed to be a central point of discussion. Cost was referenced a few times. Emergency medical technicians were added later and were placed in the firefighter classification. A few interim committee reports observed stress and a job situation should not be across-the-board determinations for movement from KPERS to KP&F.

The Joint Committee recommends further discussion and study may be necessary regarding state and local corrections, KDWPT, and similar groups that want to join KP&F, perhaps through a subcommittee of a standing committee, the appointment of a select or special committee—consisting of members knowledgeable about the interrelationships between pensions, law enforcement, and corrections—or through the creation of a task force that could rely on outside expertise. The Joint Committee recommends a few guidelines to use when considering the inclusion of new employee groups into KP&F. Those positions should meet the plan's existing employee definitions. The inclusion of related but not similar employees into KP&F could invite unintended issues, such as the transition costs from KPERS to KP&F for current employees and their vesting in either or both plans. Those issues must be thoroughly explored and answered. Lastly, the Joint Committee suggests new approaches to compensation, work conditions, management practices, and the group's current KPERS plan should be considered as a better means to recruit and retain personnel rather than transferring these groups to KP&F.

The Joint Committee recommends KPERS staff study the legal definition of alternative investments and reevaluate the extent to which other investments, such as bank loans and other yield-driven assets, should be classified as alternative investments. For purposes of transparency, the Retirement System's alternative investment portfolio should be readily understandable to policymakers, pension administrators, taxpayers, and KPERS members.

Finally, the Joint Committee expresses concern in the Legislature's current level of knowledge regarding the Board's triennial experience study and its methods and assumptions. The assumed rate of return, which this study determines, is one of the foundation stones that ensures there is greater generational equity in KPERS. However, if the analyses are too limited in scope or overly pessimistic in tone, then the assumed rate of return may become too averse to risk, leading to a self-fulfilling expectation of muted performance that could result in less generational equity in KPERS. The Joint Committee recommends those standing committees of the House and Senate that are assigned pension legislation during the 2020 Session hold hearings on the Board's newly approved rate of return and the assumptions behind it.