# Report of the Joint Committee on Pensions, Investments and Benefits to the 2022 Kansas Legislature

**Chairperson:** Representative Steven Johnson

**Vice-chairperson:** Senator Jeff Longbine

**Other Members:** Senators Brenda Dietrich, Michael Fagg, Cindy Holscher, and Pat Pettey; and Representatives Jesse Borjon, Broderick Henderson, Jim Kelly, Annie Kuether, Sean Tarwater, Carl Turner, and Rui Xu

**Charge**

***Monitor, Review, and Make Recommendations Regarding the Retirement System***

KSA 2020 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 exceptions for working after retirement (KSA 74-4914 and 74-4937).

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# Joint Committee on Pensions, Investments and Benefits

## Annual Report

### Conclusions and Recommendations

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

- **Annual valuation report and total fund performance.** The Committee commends the outstanding work of the Kansas Public Employees Retirement System (KPERS) Board of Trustees (Board) and KPERS staff in the continued improvement of the unfunded actuarial liability and the overall funded ratio. The Committee recommends the Legislature meet funding requirements and work with KPERS on its cash position needs to provide certainty and funding.

- **KPERS Board of Trustees.** The Committee requests the Board review retiree cost-of-living adjustments and suggests the Board make a recommendation regarding this issue to the 2022 Legislature. The Committee also recommends that any retiree cost-of-living-adjustment legislation be directed to the House Committee on Appropriations and the Senate Committee on Ways and Means and suggests such adjustment be funded in advance (*e.g.*, with a lump-sum payment).

- **Layered payments.** The Committee recommends the Legislature review the 2017 and 2019 employer contribution deferrals (currently totaling $254.0 million) and consider whether to pay them in full in 2022 or on an expedited repayment schedule. The Committee notes the current repayment schedule is based on a 20-year schedule.

- **Pension bonds.** The Committee recommends the appropriate standing committees review the possibility of issuing additional pension funding bonds if interest rates remain favorable, or consider using some of the projected State General Fund surplus ending balance to make additional contributions toward the reduction of KPERS unfunded actuarial liability.

- **Legislation – Sale of State surplus property.** The Committee will introduce one bill, which would remove the statutory language (KSA 75-6609) requiring 80 percent of the proceeds from the sale of State surplus property (such as land and buildings) be credited to the Kansas Public Employees Retirement Fund and applied to the unfunded actuarial liability.

- **Deferred Retirement Option Program (DROP) review.** The Committee recommends standing committees review the expansion of DROP to all Kansas Police and Firemen's Retirement System employers (state and local). The Committee notes that currently, only Kansas Highway Patrol troopers and Kansas Bureau of Investigation agents are eligible for the pilot program.

- **Retirement System – Tier 3 formula.** The Committee recommends the ongoing evaluation by the appropriate standing committees of the Tier 3 dividend formula to provide equity as intended and consider the overall benefit value.

- **Working-after-retirement statutes.** The Committee recommends the appropriate standing committees review KPERS working-after-retirement provisions, and specifically the existing waiting period and employer contributions for assessments, all within the context of the Internal Revenue Service (IRS) guidelines.

- **KPERS-Corrections.** The Committee recommends the appropriate standing committees review the possibility of the KPERS-Correctional option for local jailers.

***Proposed Legislation:*** One bill.

## Background

The Joint Committee on Pensions, Investments and Benefits (Committee), created in 1992, is authorized by KSA 2020 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 8, 2021, to receive reports and updates from the KPERS administration on the December 31, 2020, actuarial valuation and performance of the pension obligation bonds; review the KPERS Tier 3 dividend formula; and discuss the Board investment return assumptions and the Deferred Retirement Option Program (DROP). The Committee also received updates on the retirement experience during the COVID-19 pandemic and the pension administration system.

### KPERS 2020 Actuarial Valuation

The Committee reviewed the latest actuarial valuation, which serves as a snapshot of the financial condition of the Retirement System as of December 31, 2020. 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 2020 valuation is used to set the fiscal year (FY) 2024 contribution rates for State/School employers and calendar year (CY) 2023 contribution rates for local employers and serves as the baseline for any cost studies in the 2022 Legislative Session.]

As of December 31, 2020, the actuarial value was estimated to be $22.42 billion. Actuarial assets are calculated by averaging, or "smoothing," investment gains and losses over a five-year period. There is a net gain of $930.0 million to be realized in the outlying years. Net investments on a calendar-year basis were 11.1 percent (market value). Due to smoothing, the return on actuarial assets was 9.3 percent.

The Retirement System's overall funded ratio of assets to liabilities improved from 70.0 percent (2019 valuation) to 72.5 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 $9.0 billion (2018 valuation) to $8.5 billion. The Executive noted that for funding to remain at a "steady state," State/School Group employer contributions in FY 2022 will need to be $589.0 million, which includes $87.1 million for the normal employer cost rate, $476.1 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 13.33 percent in FY 2023 to 12.57 percent in FY 2024. The statutory employer contribution rate continues to be at the full ARC rate for FY 2024, the fourth 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 $134.0 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 $500.0 million pension funding bond proceeds authorized by 2021 HB2405 were not included in the 2020 valuation as the proceeds were received too late to be included, but were included in the cost projections. The Committee and the Executive Director discussed the funding projections presented and the anticipated investment experience.

### Pension Obligation Bond Proceeds

The Executive Director presented on 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 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.

The average annualized total returns for the 2004C and 2015H bond issues, as of October 31, 2021, were 8.14 percent and 9.76 percent respectively. As of October 31, 2021, the two bond series had exceeded interest cost by approximately $1.1 billion (2004C, $642.0 million; 2015H, $454.0 million). The 2021 issuance return of two months totaled $2.5 million above the interest cost. 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, 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 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 5-year average net compound rate of return above 6.0 percent, as determined by the Board for the calendar year and the 4 preceding years.

The Planning and Research Officer noted CY 2020 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 three times. Increases occurred in CY 2017 (1.1 percent), CY 2019 (0.825 percent), and 2020 (2.475 percent). The officer also indicated, assuming the returns through September hold, an estimated 4.4 percent could occur in CY 2021.

## KPERS Board's Investment Return Assumption

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 21, 2016, valuation, the Board reduced the return assumption from 8.0 percent to its current 7.75 percent. The Executive Director provided information that the Board reviewed in more detail on the investment-rate-of-return assumption at its October meeting; he stated the Board requested additional information to review and possibly act upon in future Board meetings.

Since 2010, the median investment return assumption was reduced from 8.0 percent to 7.0 percent. A total of 23 states had a return assumption of 7.5 percent or more, and Kansas was one of two states that had an assumption of 7.75 percent or more in a survey of 131 retirement plans.

The estimated impact on the UAL would be an increase of $610.0 million for each 0.25 percent reduction in the investment return assumption. The 0.25 percent return reduction also would reduce the funded ratio by an estimated 2.0 percent.

The Executive Director stated that when the Board established the appropriate investment rate assumption, it would also make changes to the amortization method to pay for any adjustment. This could include level dollar or level percentage of pay. The Legislature has also delegated the amortization decisions to the Board.

## KPERS Deferred Retirement Option Program

A sheriff, on behalf of the Kansas Association of Chiefs of Police, the Kansas Sheriffs Association, and the Kansas Peace Officers Association, stated many Kansas law enforcement agencies need help in recruiting and retaining officers. To help alleviate the problem, he requested all local agencies under the Police and Firemen's Retirement System (KP&F) be allowed to participate in the Deferred Retirement Option Program (DROP).

The KPERS Planning and Research Officer provided information on the DROP for Kansas 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.

He indicated that the average DROP participant enrolled in the program about seven months younger than other members who elected to retire. The average time in DROP is 4.7 years, resulting in a KHP member in DROP staying longer on the job and retiring later. This prompted discussion with the Committee on the possible impact of the DROP expansion to local law enforcement agencies.

### COVID-19 Pandemic and the Impact on KPERS Retirement Experience

The KPERS Planning and Research Officer noted that the average of retirements over the previous five years has been about 5,200 per year. However, the number of retirements in the first half of CY 2020 was lower than average and began to increase in the second half of the year. He said retirements in FY 2021 increased above numbers for the same month in FY 2020 in 10 of the 12 months. This equates to a 13 percent increase, or an additional 636 retirements, when comparing FY 2021 to FY 2020.

While retirements had increased over the past 18 months, there was no indication that the retirement pattern would change. The KPERS Planning and Research Officer said the COVID-19 pandemic was assumed to be the primary driver for the increase. This would not indicate a change in the long-term retirement pattern.

### KPERS Pension Administration System Modernization Project

The Executive Director said 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 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 multiyear 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 a pilot project, KPERS decided to continue its relationship with the current provider to create a new base system. The current estimate for expenditures in FY 2022 is $6.6 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 maintained at around $9.0 million for FY 2024 and FY 2025 and then drop to an estimated $3.0 million in FY 2026 as the modernization project is completed.

## Conclusions and Recommendations

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