KPERS Update

System Overview

Presented by:

Alan D. Conroy, Executive Director

Phone: 785-296-6880

Email: aconroy@kpers.org

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KPERS

Topics

- KPERS Overview
- Actuarial Impact of Reduction in Active Members
- Final Average Salary
- 457(f)

KPERS

Kansas Public Employees Retirement System

Dependable Benefits. Trusted Partner.

KPERS is a fiduciary providing retirement, disability and survivor benefits to our members and their beneficiaries with a 98-member staff.

KPERS administers three statewide, defined benefit plans for public employees.

- Kansas Public Employees Retirement System
- Kansas Police and Firemen's Retirement System
- Kansas Retirement System for Judges

KPERS partners with more than 1,500 state and local government employers.

- State of Kansas
- 286 school districts
- 105 counties
- 424 cities and townships
- Other employers include libraries, hospitals, community colleges and conservation districts

KPERS Overview

Board of Trustees

KPERS Overview

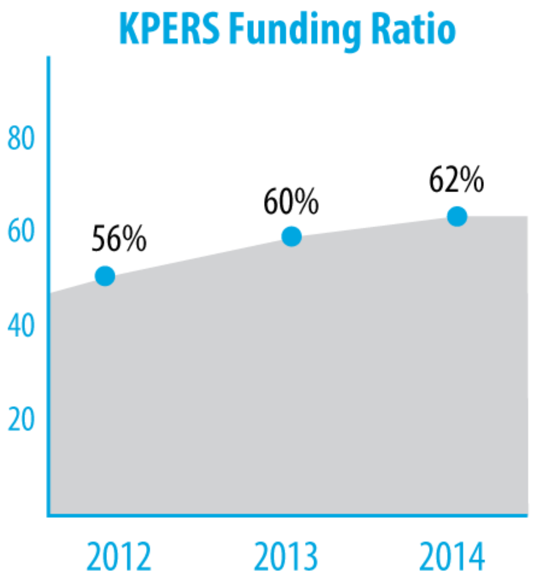
How KPERS Works

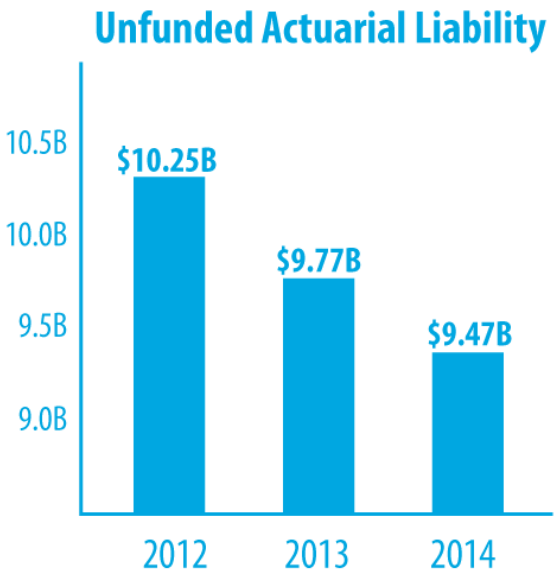
- Legislature defines benefits and funding
  - Membership eligibility
  - Vesting
  - Employee and employer contributions
  - Benefit formula
  - Service credit
  - Retirement eligibility
- Actuary estimates how much benefits will cost
- Employers and members make contributions
  - Over last 20 years, employer contributions equal 27% of revenues, and employee contributions equal 17%
- KPERS invests the money over time (56% of revenue over last 20 years)
- KPERS pays benefits with contributions + investment earnings - expenses
- KPERS is not like Social Security
  - Social Security utilizes contributions from current employees to pay the benefits of current retirees
  - KPERS benefits are "pre-funded"; current contributions are invested to pay benefits down the road

KPERS Overview

Steady Funding Progress

- Generally, KPERS funding is slowly improving and headed in the right direction
- KPERS is on target to be fully funded in 2033
- The sale of bonds in August 2015 has improved the overall health of the Trust Fund





KPERS Overview

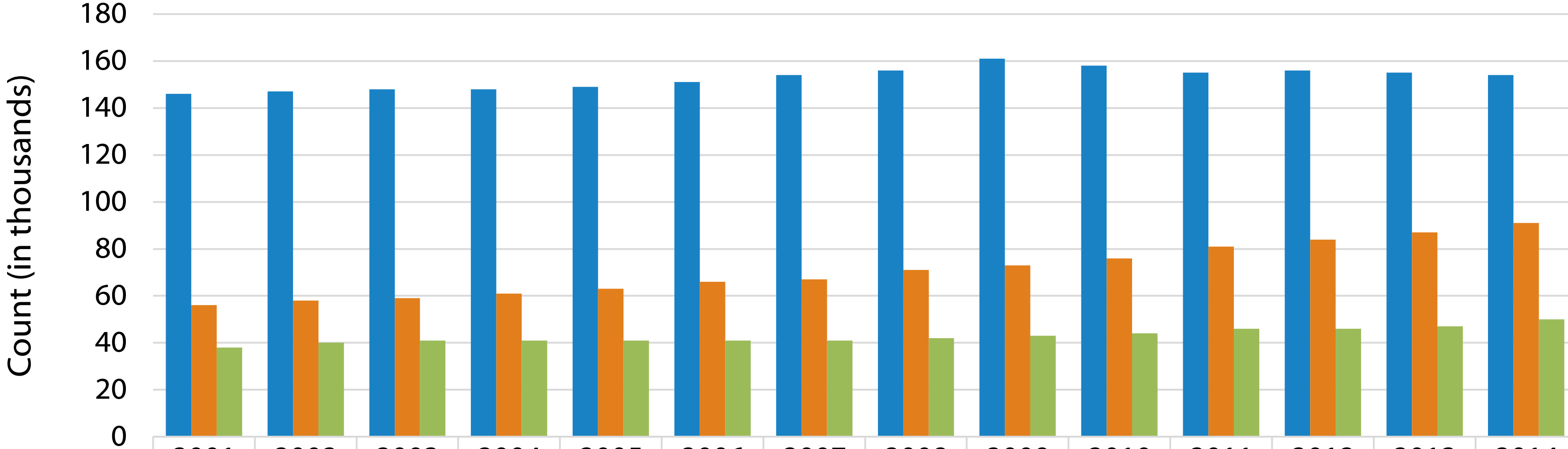
Bond Approval and Investment

- The 2015 Legislature approved $1.0 billion in Pension Obligation Bonds.
  - The 30-year bonds were sold in August at a composite rate of 4.688%.
- The expectation is that, over time, KPERS' investment returns will exceed interest on the bonds
- KPERS received the $1.0 billion on August 20th and was fully invested within a few days
- Generally invested across the KPERS asset allocation (a well-diversified, long-term portfolio)
- As provided by the legislation, the entire $1.0 billion was credited to the KPERS State/School unfunded actuarial liability
- The bond proceeds immediately improve the funding status of the State/School group, but do not change the amortization schedule, which is to be fully funded by FY 2033

KPERS Overview

System Statistics

Total active and retired members (total system)



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Active	146	147	148	148	149	151	154	156	161	158	155	156	155	154
Retired	56	58	59	61	63	66	67	71	73	76	81	84	87	91
Inactive	38	40	41	41	41	41	41	42	43	44	46	46	47	50

0.4% average annual increase in active count since 2001 –flat or declining for last few years.
3.8% average annual increase in retiree count since 2001 (4.4% increase for 2014).

Actuarial Impact of Reduction in Active Members

- Factors affecting –
  - Actuarial Liability
  - Contribution rates

KPERS

Workforce Changes

Factors affecting actuarial impact

- Various circumstances may result in a short or long-term decline in the number of active members in a plan
- Actual experience that varies from these assumptions result in actuarial gains or losses
- The ultimate actuarial impact of such a decline on actuarial measures (such as funded ratio, actuarial liability, and contribution rates) depends on a complex range of factors

Workforce Changes

Factors affecting the actuarial liability

- Funding benefits for fewer members does not necessarily reduce a plan's actuarial liability
- Whether the plan's actuarial liability declines depends on –
  - The demographics of the members who leave covered employment (e.g., short or long service)
  - Whether the actuarial assumptions would have anticipated their departure (e.g., age and number retiring greater than expected)

Workforce Changes

Factors affecting contribution rates

- There are two parts to the **actuarial contribution rate**
  – The **normal cost rate** (cost assigned to the current year of service for **active** members)
    - FY 2018 State/School Group *employer* normal cost rate: 2.4%
  – The **unfunded actuarial liability contribution rate** (payment to finance the unfunded actuarial liability)
    - FY 2018 State/School Group unfunded actuarial liability rate: 12.49%
    - FY 2018 State/School Group statutory rate: 9.61%
  – The impact on the contribution rate has to consider both of the component pieces of the contribution rate

Workforce Changes

Factors affecting contribution rates

- Normal cost
  - Typically the normal cost rate will change very little if at all
  - However, the dollar amount of normal cost contributions would decline proportionately to the decline in covered payroll. For example –
    - A 2% employer normal cost rate on $1 billion payroll = $20 million
    - A 2% employer normal cost rate on $0.8 billion payroll = $16 million

Workforce Changes

Factors affecting contribution rates

- A decline in number of active members does not necessarily lower the unfunded actuarial liability
  - The unfunded actuarial liability is an obligation reflective of benefits attributable to **past years of service**
  - The unfunded actuarial liability operates like a fixed amount of debt that generates the dollar amount of the unfunded actuarial liability payment
  - If actual covered payroll growth is less than the actuarial assumption, the dollar amount of the unfunded actuarial liability contributions would be spread over a smaller payroll base, resulting in a higher contribution rate

Workforce Changes

Factors affecting contribution rates

- The State group is much smaller than the School group
  - State Group: 22,740 active members
  - School Group: 85,347 active members
- Therefore, a declining active workforce for the State is not expected to have a significant impact on the overall State/School contribution rate
- In general, declines in the number of active members often have an adverse impact on the long-term funding of a defined benefit plan

Final Average Salary

- One component of a traditional pension formula
- A closed, declining group can use "add-ons" in final average salary calculation
- State of Kansas has limits on sick and annual leave payouts

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Final Average Salary

Compensation, salary and final average salary

- Pension benefits are based on the formula

  Final Average Salary X Years of Service X Multiplier =

  Annual retirement benefit

- Final average salary is based on average of three to five years of "compensation" or "salary"
  - Depends on member's plan (e.g., KPERS or KP&F), tier, and membership date
  - Somewhat different statutory definitions of "compensation" and "salary"
  - Both "compensation" and "salary" definitions include all salary and wages payable to a member for personal services performed for a participating employer

Final Average Salary

Using add-ons in final average salary

- Sick and annual leave payouts made at retirement are used in final average salary calculation for some members
  - Referred to as pre-1993 members
  - The final average salary calculation uses
    - The highest 3 years of compensation without add-on payments; **<u>or</u>**
    - The highest 4 years of compensation with add-on payments

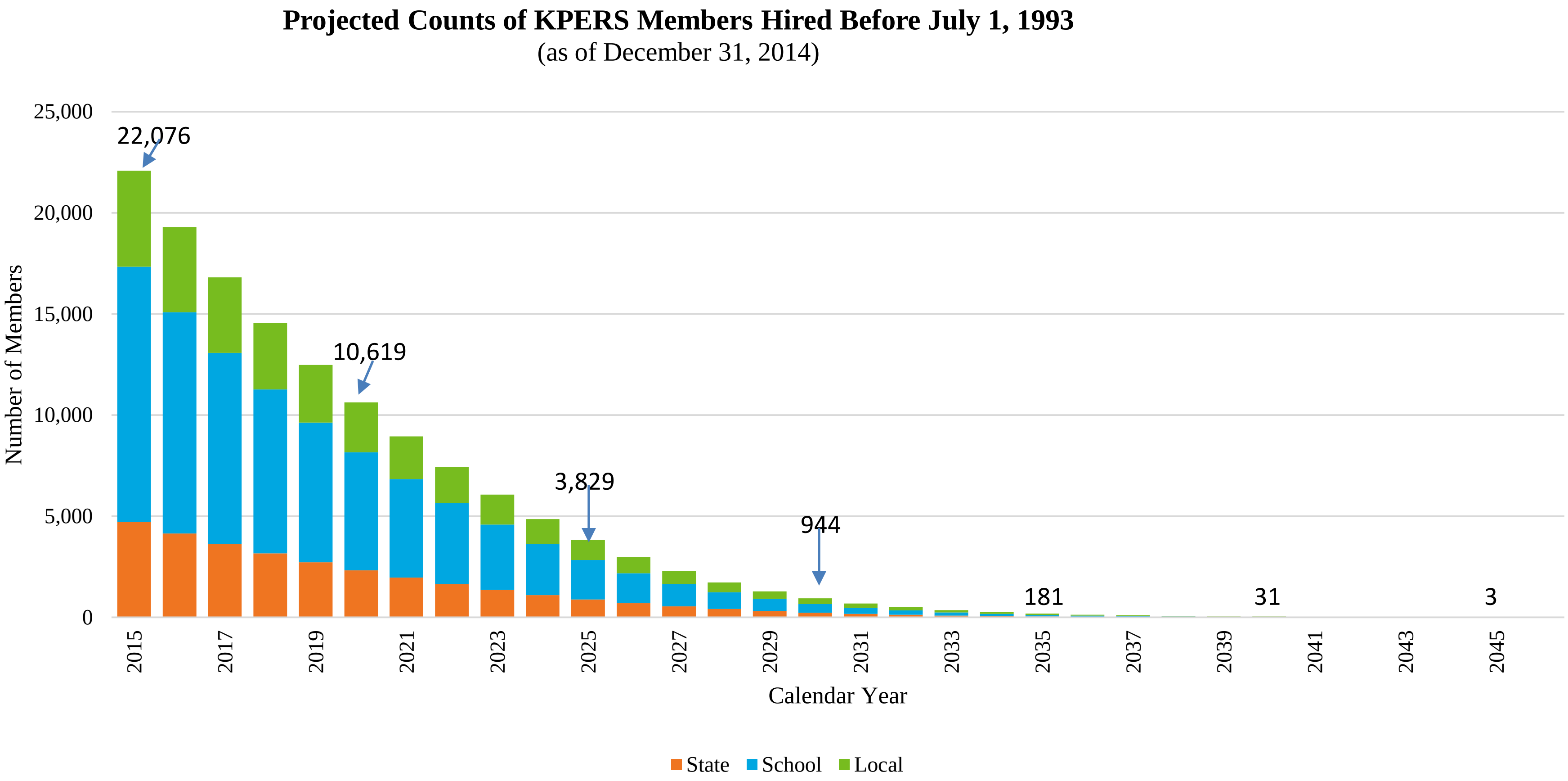
Final Average Salary

Pre-1993 members

- This group of members is closed and can only decline going forward
- There were 22,076 members in this group as of 12/31/2014
- The group is projected to decline to 10,600 by 2020 and 3,800 by 2025

Final Average Salary

Pre-1993 members



Final Average Salary

Use of add-ons

- 5,506 KPERS members retired in CY 2014, of which 3,092 (56%) were in the pre-1993 group
- Approximately 22% of all KPERS retirees in CY 2014 (1,241 of 5,506) used the four-year final average salary with add-ons*
- Of the pre-1993 group retirees that retired in CY 2014, about 40% (1,241 of 3,092) used the four-year final average salary*

*These numbers are unaudited counts and are the best estimates available.

Final Average Salary

Impact on Benefits

- Plan provisions such as the use of add-ons in calculating benefits can, in some cases, elevate member benefits

- The impact of including vacation and sick leave on a member's benefit levels is sensitive to –
  - Employer leave policies
  - The member's use of leave throughout service
  - Late-career salary increases

Final Average Salary

Example of Impact on Benefits

- Assumptions:
  - Member's highest career salary is $40,000
  - 23 years of service
  - Payout for 90 days of vacation and sick leave (the maximum available to most state employees)
- Increase in monthly benefit:
  - 8.65% or about $116 per month, if the member received no pay increases over those four years
  - 7.85% or about $103 per month, if the member's pay increases averaged 2% over those four years
  - 7.47% or about $97 per month, if the member's pay increases averaged 3% over those four years

Final Average Salary

Actuarial Costs to the System

- The provisions which allow for the use of a 4-year final average salary currently are included in the actuarial assumptions
- This benefit provision, like the rest of the KPERS System, is designed to be pre-funded
- Actuarial cost study (based on the December 31, 2014, valuation) projected that total elimination of add-ons would have reduced KPERS' unfunded actuarial liability by 0.06% ($52 million)

Final Average Salary

Factors Reducing Potential Cost Savings

- This $52 million projection is overstated
  - The size of the closed group would have decreased during CY 2015
  - Eliminating use of add-ons may lead retirement-eligible members to retire before effective date
    - These members retire earlier than expected, resulting in –
      - Faster decreases in the size of the closed group, with fewer members ultimately impacted
      - An actuarial experience loss due to spike in retirements before expected by actuarial assumptions
    - Paying benefits for a longer period of time than expected under actuarial assumptions reduces net savings

Final Average Salary

Legislative Actions

- The Legislature has taken steps over the years to control the impact of the final average salary's definition on benefits and actuarial costs

- The 1993 Legislature closed the group of members who could use a four-year final average salary with add-ons

- The 1997 Legislature added "spiking" provisions
  - Requires employers to pay the actuarial cost of any member whose final average salary is increased by more than 15% due to add-on payments
  - In 2014, the spiking provisions applied to 58 retirements (1.0% of System-wide 2014 retirements)
  - 13 were KPERS members, representing 0.24% of all 2014 KPERS retirements.
  - In 2014, spiking provisions applied to 1 school district retirement and 1 state agency retirement from KPERS

Final Average Salary

Existing Limits

- The State of Kansas has existing limits on sick and annual leave payouts
- State employees can be compensated for:
  - 30 days of sick leave, if the employee has eight or more years of state service and has accumulated at least 100, but less than 125 days of sick leave;
  - 45 days of sick leave, if the employee has completed 15 or more years of state service and has accumulated at least 125, but less than 150 days of sick leave; and
  - 60 days of sick leave, if the employee has completed 25 or more years of state service and has accumulated 150 or more days of sick leave
- State employees with 15 or more years of state employment may accumulate up to 240 hours (30 days) of vacation leave.

Final Average Salary

Legal Implications

- Case law has upheld contractual nature of vested public pension benefits

- Previous legislative changes in the definition of final average salary have –
  - Been made for future members only; or
  - Permitted optional calculations under the prior definition to avoid disadvantaging vested members without a compensating benefit

- Similar considerations apply to any further changes to the policy

457(f) Plans

- Different than the State's deferred compensation (457(b)) plan
- Rare for KPERS members
- Effect limited by current statutes

Deferred Compensation

457 plans

- A **457(b)** plan (deferred compensation plan) offered by a governmental employer typically covers most, if not all employees
  - Any individual receiving a state paycheck is eligible for the KPERS 457 plan
  - Employees chooses how much of their pay to contribute
  - Local employers may offer a 457(b) plan
- A **457(f)** plan is used by employers to retain certain employees
  - Usually limited to particular key employees
  - The employer establishes and funds the plan in a contract with the employee
  - The employee does not receive any income from the contract until the end of the contract period

Deferred Compensation

457(f) plans

- Under KPERS' statutory definition of compensation and salary, 457(f) funds received at the end of the contract period are included
- IRS code permits 457(f) agreements
- Use is extremely rare by KPERS employers
  - Out of about 90,000 retirements in the past 20 years, KPERS is aware of a maximum of 3 times in which 457(f) benefits were included in final average salary
- "Cap law" limits the effect of the 457(f) benefits on final average salary
  - If a member's compensation for any year used in calculating his or her final average salary is more than 15% higher than the preceding year, the amount which exceeds the 15% is not included in compensation (7.5% for KPERS 2 members)
  - Therefore, the increase in a member's final average salary due to 457(f) benefits would be capped at 5% for KPERS 1 members and 3% for KPERS 2 members

KPERS

Deferred Compensation

457(f) plans

- 457(f) benefits would have smaller impact on KPERS 3 cash balance plan benefits
  - KPERS 3 benefits are calculated based on account balances, rather than final average salary
  - KPERS 3 accounts reflect compensation earned throughout career – not the highest three to five years
  - Contributions on 457(f) benefits paid at or near retirement would earn interest for very limited period of time

Salary Limitations

IRS limits compensation subject to contributions

- The IRS sets a **contribution limit** based on annual earnings and membership date
  - Caps earnings on which contributions are made
  - Does not cap actual earnings
  - Higher limit if membership date is before July 1, 1996
- The IRS also sets a maximum limitation on the gross annual **benefit** amount for a member
- The IRS sets these limits for each calendar year
- Kansas has adopted the IRS limitation levels by statute

Summary

- KPERS Overview
- Actuarial Impact of Reduction in Active Members
- Final Average Salary
- 457(f) Plans
- Questions