

MINUTES OF THE HOUSE COMMITTEE ON APPROPRIATIONS.

The meeting was called to order by Chairperson Representative Kenny Wilk at 9:00 a.m. on January 22, 2002, in Room 514-S of the Capitol.

All members were present except: Representative Landwehr, Excused  
Representative Hermes, Excused

Committee staff present: Alan Conroy, Legislative Research  
Amy Kramer, Legislative Research  
Julian Efrid, Legislative Research  
Jim Wilson, Revisor of Statutes  
Mike Corrigan, Revisor of Statutes  
Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee: Steve McElhaney, William M. Mercer, Inc.  
Pat Beckham, Milliman USA, Omaha, Nebraska

Others attending: See Attached

Representative Nichols moved for the introduction of proposed legislation regarding KPERS, participating service credit multiplier in benefit formula increased. Motion was seconded by Representative Shriver. Motion carried.

Representative Nichols moved for the introduction of proposed legislation related to establishing a job market study. Motion was seconded by Representative Shriver. Motion carried.

Representative Nichols moved for the introduction of proposed legislation regarding KPERS, vesting after five years. Motion was seconded by Representative Feuerborn. Motion carried.

Representative Wilk moved to introduce legislation regarding scientific research and development facilities. Motion was seconded by Representative Nichols. Motion carried.

Steve McElhaney, spokesperson for William M. Mercer, Inc., informed the Committee of the results of their actuarial audit of the December 31, 2000, actuarial valuation of the Kansas Public Employees Retirement System as prepared by Milliman USA (Attachment 1). Although the overall actuarial methods were found to be reasonable and appropriate, areas suggested for further investigation or study by KPERS and the consulting actuary are:

- Actuarial cost methods—one actuarial cost method for all three systems
- Contribution lag period—shorted time between valuation date and start of fiscal year for which actuarial contribution rates are applied
- Mortality assumptions
- Data review
- Test cases review—inactive vested liabilities are slightly overstated

Pat Beckham, Milliman USA, Omaha, stated that 8% return is considered the common rate for most retirement systems.

Mr. McElhaney then addressed the completed study on post-retirement benefit adjustments as contracted for by the LCC (Attachment 2).

The meeting was adjourned at 10:30 a.m. The next meeting is scheduled for Wednesday, January 23, 2002.



# **Actuarial Audit of the Kansas Public Employees Retirement Systems**

January 2002

HOUSE APPROPRIATIONS

DATE 1/22/02  
ATTACHMENT 1

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William M. Mercer, Incorporated  
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# I. EXECUTIVE SUMMARY

## ***Purpose and Scope of the Actuarial Audit Review:***

William M. Mercer, Inc. was engaged by the Legislative Coordinating Council of the Kansas Legislature (on behalf of the Joint Committee on Pensions, Investments and Benefits of the Kansas Legislature) to conduct an actuarial audit of the December 31, 2000 actuarial valuation of the Kansas Public Employees Retirement System which was prepared by Milliman USA, consulting actuary to the System.

The primary purpose of the audit was to perform an independent verification and analysis of the assumptions, procedures, and methods used by Milliman USA in preparing the valuation. The valuation report reviewed covered the Kansas Public Employees Retirement System (KPERS), the Kansas Police and Firefighter's Retirement System (KP&F) and the Kansas Retirement System for Judges (Judges).

## ***Statement of Key Findings:***

*Based upon a thorough review of the December 31, 2000 actuarial valuation report, we are pleased to report that we found the work to be reasonable and performed in accordance with generally accepted actuarial principles and practices. We found that the actuarial methods and assumptions are reasonable and appropriate and that the work was performed by fully qualified actuaries.*

## ***Audit Exceptions:***

It is important to understand that in selecting and recommending actuarial methods and assumptions, there is a great deal of professional judgment involved. In making the above Statement of Key Findings, we have not attempted to substitute our judgment for that of the consulting actuary to the Fund. However, as a part of our review, we have identified a number of areas where KPERS and its consulting actuary should undertake further investigation or study. These areas are described under the "Comments" within each of the sections that follow this Executive Summary and are summarized below.

Actuarial cost methods: We believe that advantages would be derived by using a single actuarial cost method for all three systems.

Contribution lag period: The proposed “lag” between the valuation date and the start of the fiscal year for which actuarial contribution rates are applied is 30 months. We would prefer that this period be shorter.

Mortality assumptions: We have made a number of comments concerning the mortality tables used in the valuation:

- The mortality tables used for non-disabled KPERS retirees do not appear to provide for sufficient margin for future improvements in mortality. At some point, tables with lower mortality rates may need to be adopted and this will result in increased actuarial liabilities and actuarially determined employer contribution rates.
- The mortality tables used for disabled KP&F retirees are overstating the actual rates of mortality. Adoption of mortality more in line with plan experience would result in increased actuarial liabilities and actuarially determined employer contribution rates.
- The mortality tables used for active members overstate the mortality compared to plan experience. We recommend using tables appropriate for active members, although the effect on valuation results will probably be minimal.

Data review: We found a few inaccuracies with regard to Milliman’s use of KPERS membership data. However, these are relatively minor and do not have a material affect on valuation results.

Test cases review: We believe that the inactive vested liabilities of KP&F and KPERS are slightly overstated, based on an estimation methodology used by Milliman to recognize the liability associated with participants who are inactive vested members in one system, and active members in another system.

*8% is used by most retirement plans. - most common rate.*

# Postretirement Benefit Adjustment Study

## Kansas Public Employees Retirement System

December 2001

HOUSE APPROPRIATIONS

DATE 1/22/02

ATTACHMENT 2

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William M. Mercer, Incorporated  
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## I. BACKGROUND

William M. Mercer, Inc. was retained by the Legislative Coordinating Council of the Kansas Legislature (on behalf of the Joint Committee on Pensions, Investments and Benefits of the Kansas Legislature) to provide a postretirement benefit adjustment study based upon the benefits provided under the Kansas Public Employees Retirement System (KPERS). The scope of the study covers the following:

1. Test the KPERS initial income replacement at retirement against income replacement needs of retirees, based on an analysis of spendable income requirements, considering changes in expenditures and tax rates for retirees.
2. Define an overall benefit policy statement with regard to initial income replacement objectives at retirement and test KPERS' current and past benefit provisions against that policy.
3. Analyze the short- and long-term costs to KPERS and consider alternative financing arrangements to fund the costs associated with benefit increases.
4. Develop a policy statement addressing the need for postretirement benefit increases, and how much and when retirees and disabled members should receive benefit increases.

KPERS is an umbrella organization whose mission is to effectively administer the pension programs of three statewide public employee pension groups. All three pension systems are defined benefit retirement plans in which participating employers and employees share the cost of providing benefits. The three pension systems are:

- Kansas Public Employees Retirement System (KPERS) – covering State and School employees, Local employees, and TIAA members
- Kansas Police and Firemen's Retirement System
- Kansas Retirement System for Judges

Under KPERS, active members contribute 4% of their compensation. Employer contribution rates are set annually by statute and are currently below the level of actuarially required contribution rates determined by the KPERS actuary, Milliman & Robertson. The statutory contribution rate is scheduled to increase until the contribution rate meets the actuarial requirement. Most recent projections predict the statutory rate will not meet the actuarial rate until the year 2033. This is commonly referred to as the point of "equilibrium."



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## BACKGROUND *(continued)*

The system does not currently grant postretirement benefit increases to retirement members automatically. However, the Kansas Legislature has frequently provided significant ad hoc (one-time) increases in benefits for retired employees and more recently, disabled members. In addition, other benefit improvements have been granted to certain retirees in the form of a "13th check." The 13th check was made permanent for all who retired on or before July 1, 1987. Other historical increases have been granted on the basis of a fixed dollar increase, fixed percentage increases with minimum and maximum amounts, and a percentage increase for each year of service or year retired.

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## II. ANALYSIS OF CURRENT KPERS BENEFITS

Generally, the goal of retirement planning is to provide for a level of retirement income that will permit each retiree to maintain his pre-retirement lifestyle into his retirement. The term "replacement ratio" refers to the percentage of pre-retirement income that is provided after retirement. A number of models have been developed that attempt to derive the ideal replacement ratio for the average plan participant. However, financial planners have recognized that there are various factors unique to each individual that can have a substantial affect on that individual's own ideal replacement ratio. Therefore, for planning purposes, target replacement ratios of 70% to 80% are commonly used. For purposes of the illustrations shown within this study, we have used a common replacement ratio of 75%.

From a plan sponsor standpoint, there are two basic decisions to be made regarding the level of retirement income to be provided relative to the target:

- What combination of age and/or service should an employee attain in order to be entitled to the full target? Persons entitled to the full target are sometimes referred to as "career employees."
- How much of the target should be provided through the employer-sponsored pension plan (in contribution and social security) and how much should be provided by the employees' own savings?

### Age and Service Considerations

Regular retirement benefits under KPERS can be categorized into three types:

- Early retirement benefits are payable at age 55 with 10 years of service and include an actuarial reduction in the accrued normal retirement benefit.
- Rule of 85 benefits are payable when the age plus years of service equals or exceeds 85. The retiree receives the full accrued normal retirement benefit.
- Normal retirement benefits are payable at age 62 with 10 years of service or at least age 65 regardless of service. The retiree receives the full accrued normal retirement benefit.

The following charts show average age, service, and final average salary for employees who have retired over the last five years, for the three categories of service retirement benefits. (For purposes of this summary, retirees were allocated first to Normal Retirement before determining whether they qualified under Rule of 85).

## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

### Retiree Profiles

#### Non-School Employees

Type of Retirement	Eligibility Percentage	Profile Description	Average Age	Average Service	Final Average Salary
Early	17%	Age 55 + 10 years	58.4	16.1	\$28,429
Rule of 85	12%	Age + Service = 85	58.0	31.2	\$34,747
Normal	71%	Age 62 + 10 years or Age 65	65.3	18.5	\$24,612

#### School Employees

Type of Retirement	Eligibility Percentage	Profile Description	Average Age	Average Service	Final Average Salary
Early	24%	Age 55 + 10 years	58.2	18.8	\$31,962
Rule of 85	30%	Age + Service = 85	57.8	31.5	\$43,390
Normal	46%	Age 62 + 10 years or Age 65	65.5	17.7	\$25,185

In terms of service only for all of these retirees, the distribution is as follows

Years at retirement	Non School	School
Less than 10	14%	14%
10 - 14	23%	17%
15 - 19	19%	15%
20 - 24	16%	14%
25 - 29	11%	13%
30 - 34	9%	11%
35 - 39	5%	12%
40 or more	3%	4%

For non-school retirees, 44% retire with at least 20 years of service and 17% retire with at least 30 years of service. For school retirees, the percentages are somewhat higher. 54% retire with at least 20 years of service and 27% with at least 30 years of service. The definition of a "career employee" can be debated. However, few employers would consider employees retiring with fewer than 20 years of service to be career employees. This data indicates that about half or less of KPERS retirees would be career employees.

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## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

### Replacement ratios in relation to target

We have prepared charts that compare the level of retirement income from KPERS and Social Security combined to a target replacement ratio of 75%. The following assumptions have been made:

- KPERS' benefits are assumed to remain constant after retirement, not increased by any cost of living allowances (COLA).
- Social security benefits and the target level are both assumed to increase by the rate of inflation. Two inflation rates are illustrated – a rate of 1.5% representing low inflation and a rate of 3.5% representing moderate inflation.
- Charts are shown for the average non-school retiree. The characteristics of the average school retiree are very similar except that school retirees generally have a somewhat higher final average salary. The KPERS benefit is constant as a percentage of salary regardless of salary level. However, the replacement ratio from social security decreases as salary increases, resulting in slightly lower replacement ratios for the average school retiree.
- KPERS benefits are split between the portion provided by employee contributions and the portion provided by employer contributions.

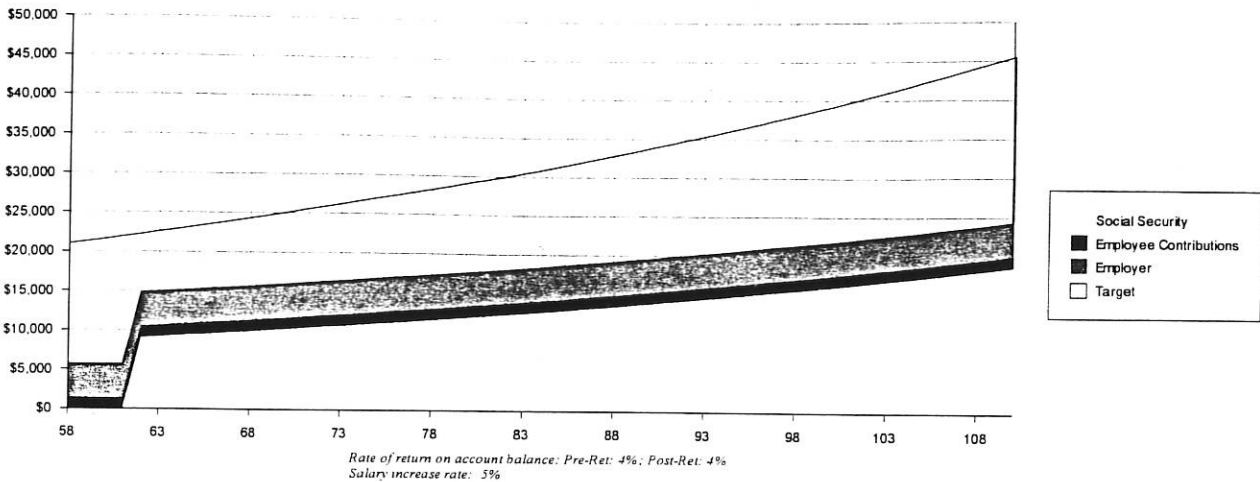
# ANALYSIS OF CURRENT KPERs BENEFITS *(continued)*

## Early retirees

The following charts illustrate retirement income compared to the 75% target for a typical early retiree:

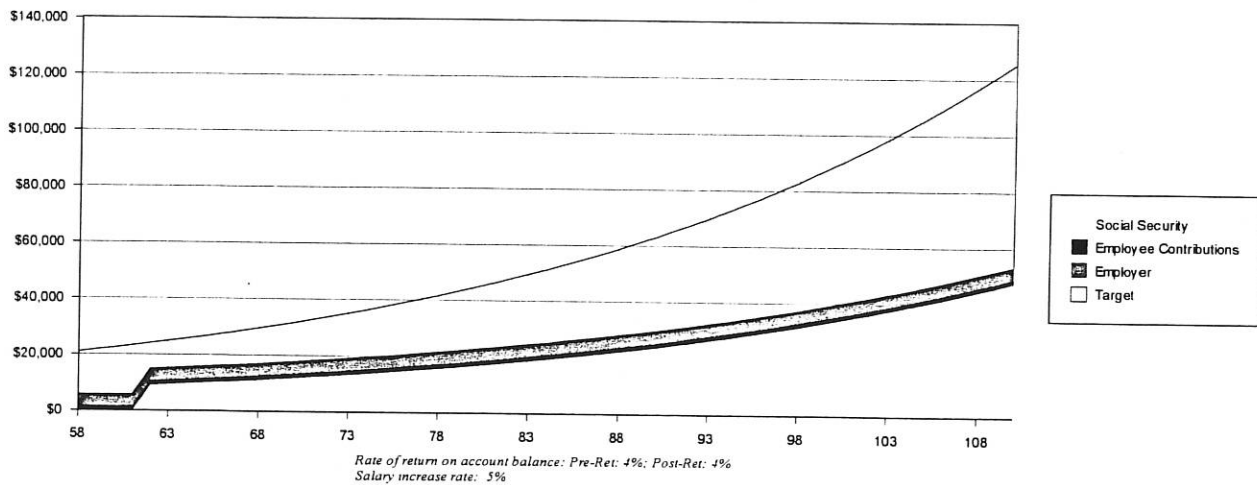
**Post-Retirement Spending Needs and Sources**

Profile of Early Retiree Data at 2000: Age = 58, Service = 16, Salary = \$28,000  
 Retirement Age = 58, Target = 75%, Tax Rate = 28%, Post-Ret COLA = 1.5%



**Post-Retirement Spending Needs and Sources**

Profile of Early Retiree Data at 2000: Age = 58, Service = 16, Salary = \$28,000  
 Retirement Age = 58, Target = 75%, Tax Rate = 28%, Post-Ret COLA = 3.5%



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## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

The typical early retiree starts at only about one-fourth of the target replacement ratio due to social security benefits not being payable until age 62. At that time the income replacement is at about two-thirds of the target. However, the average early retiree only has 16 years of service which is well short of what would generally be considered a "career" employee entitled to the full KPERS target benefit.

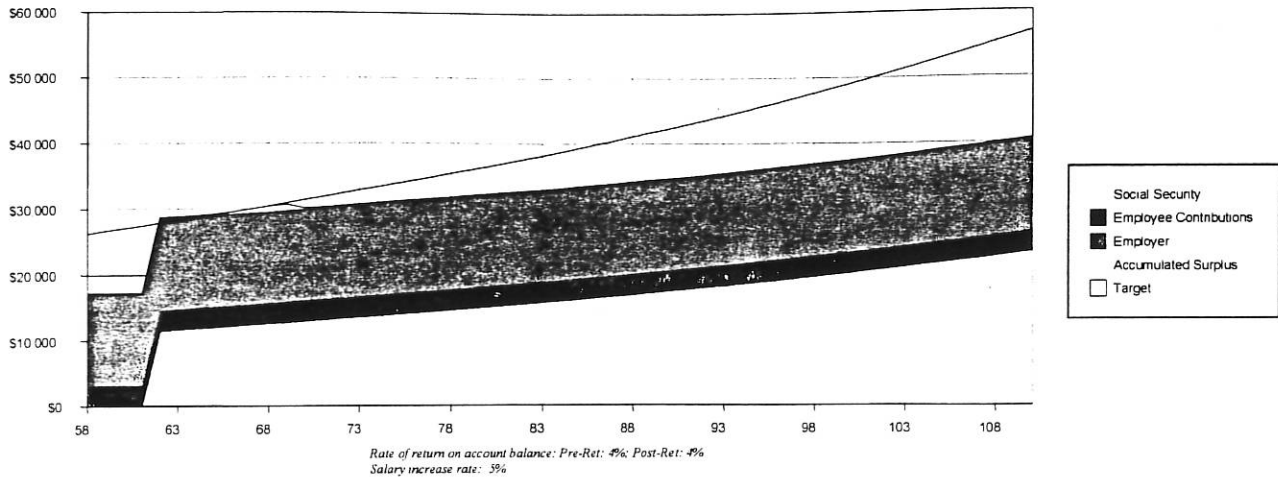
# ANALYSIS OF CURRENT KPERS BENEFITS (continued)

## Rule of 85 retirees

The following charts illustrate retirement income compared to the 75% target for typical Rule of 85 retirees:

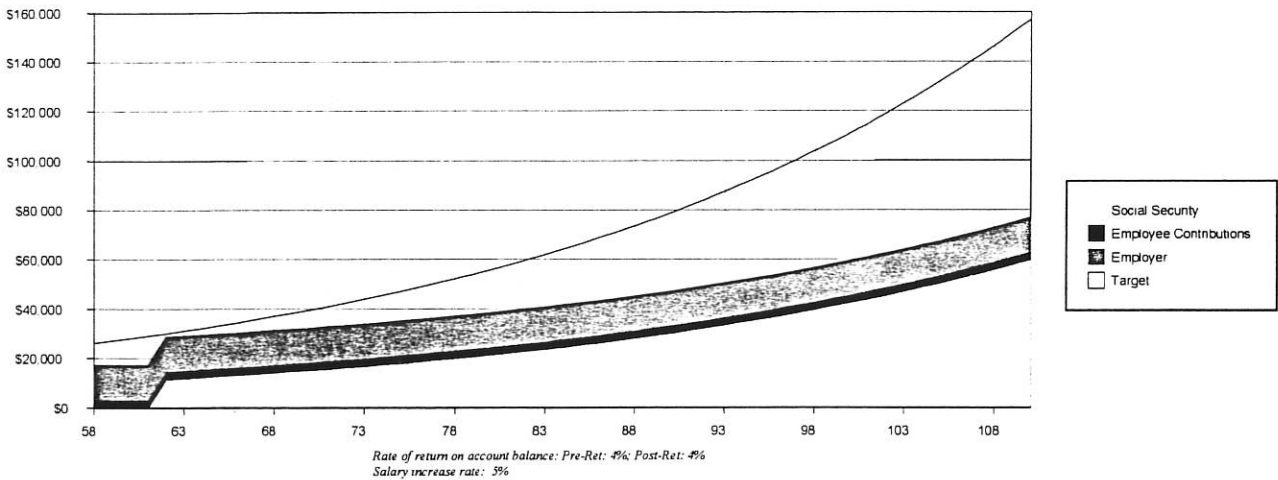
Post-Retirement Spending Needs and Sources

Profile of Rule of 85 Employee Data at 2000 Age = 58 Service = 31 Salary = \$35,000  
 Retirement Age = 58 Target = 75% Tax Rate = 28% Post-Ret COLA = 1.5%



Post-Retirement Spending Needs and Sources

Profile of Rule of 85 Employee Data at 2000 Age = 58 Service = 31 Salary = \$35,000  
 Retirement Age = 58 Target = 75% Tax Rate = 28% Post-Ret COLA = 3.5%



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## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

The typical Rule of 85 retiree starts at about 60% of the target ratio and then attains the target ratio at age 62 with commencement of Social Security benefits. However after 20 years (at age 78) the total retirement income would drop to less than 90% of the target under low inflation and less than 75% of the target income under moderate inflation. Rule of 85 retirees with their relatively long service, would generally be classified as "career employees."



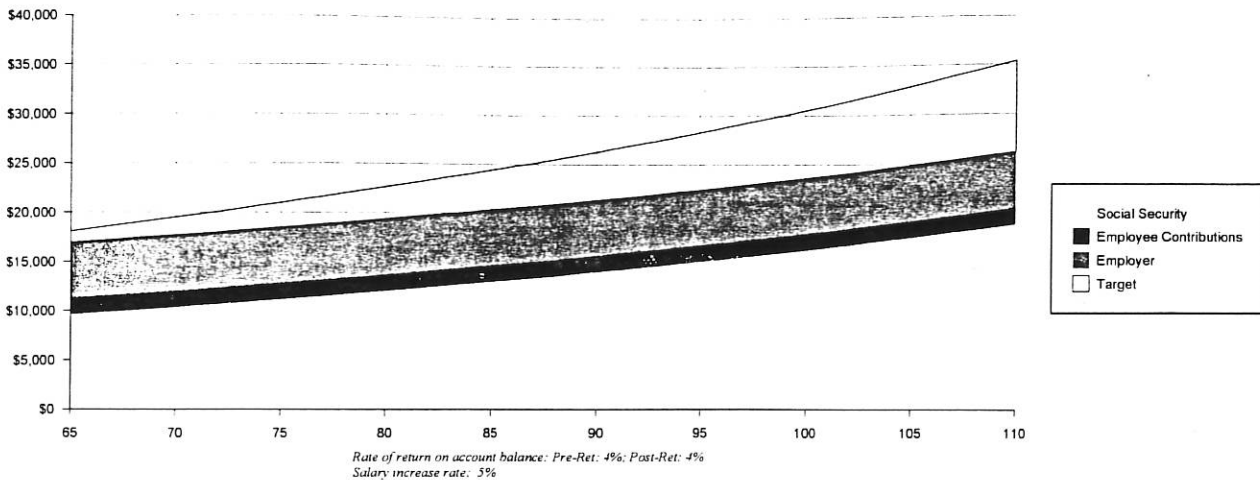
# ANALYSIS OF CURRENT KPERs BENEFITS *(continued)*

## Normal retirees

The following charts illustrate retirement income compared to the 75% target for a typical normal retiree:

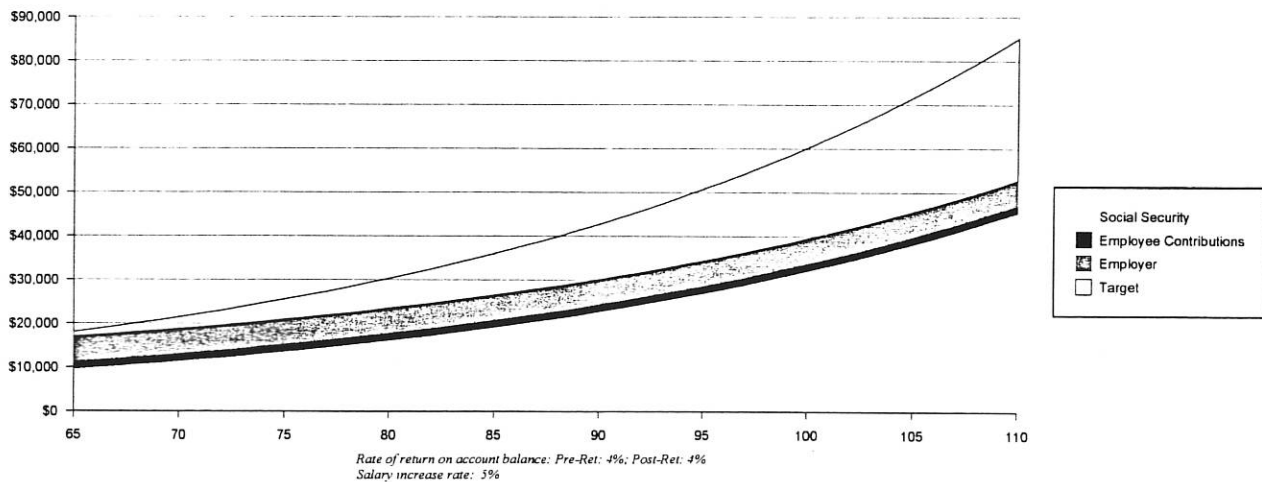
**Post-Retirement Spending Needs and Sources**

Profile of Normal Retiree Data at 2000: Age = 64, Service = 18, Salary = \$23,000  
 Retirement Age = 65, Target = 75%, Tax Rate = 28%, Post-Ret COLA = 1.5%



**Post-Retirement Spending Needs and Sources**

Profile of Normal Retiree Data at 2000: Age = 64, Service = 18, Salary = \$23,000  
 Retirement Age = 65, Target = 75%, Tax Rate = 28%, Post-Ret COLA = 3.5%



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## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

The typical normal retiree is already eligible for social security benefits at the time of retirement. Therefore his initial retirement income is approximately at 90% of the target amount even though the average service is only 18 years. After 20 years (at age 85), the retirement income drops to about 80% of the target under low inflation and to about 75% of the target under moderate inflation. With an average service of 18 years, the average normal retiree is somewhat short of a typical "career employee" definition.

### Effects of employee savings

In general, retirement planners speak of the concept of a three-legged stool. That is, retirement income should be supported by three sources:

- Social Security
- Employer sponsored pension plans
- Employee savings

The charts above have considered only the first two of these sources. With regard to the extent to which employee savings can increase these ratios to the 75% target (including future inflation), we calculated the rate of savings that would be required for the Rule of 85 and Normal Retirement profiled retirees:

	<u>Low Inflation</u>	<u>Moderate Inflation</u>
Rule of 85 Retiree	5%	13%
Normal Retiree	13%	20%

Except for the 5% rate for a Rule of 85 retiree with low inflation, these savings rates are prohibitively high for the overwhelming majority of public employees. Therefore, it is probably unreasonable to assume that all of the shortfall could be covered by employee savings alone. Nevertheless, employees should be encouraged to save and should be assisted in understanding the effects of their savings upon total retirement income.

### Comparison to other state systems

In addition to the comparison of retirement income to target ratios, it is helpful to compare the benefits of KPERS to those of other states. Within this section, we will show how the KPERS' normal retirement age, benefit accrual rates, and employee contributions compare to public employee retirement systems of other states.

In this comparison we have included only defined benefit plans and only those systems where employees are covered by Social Security. In those instances, where there are multiple systems covering public employees, we have chosen the system that covers state employees.

## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

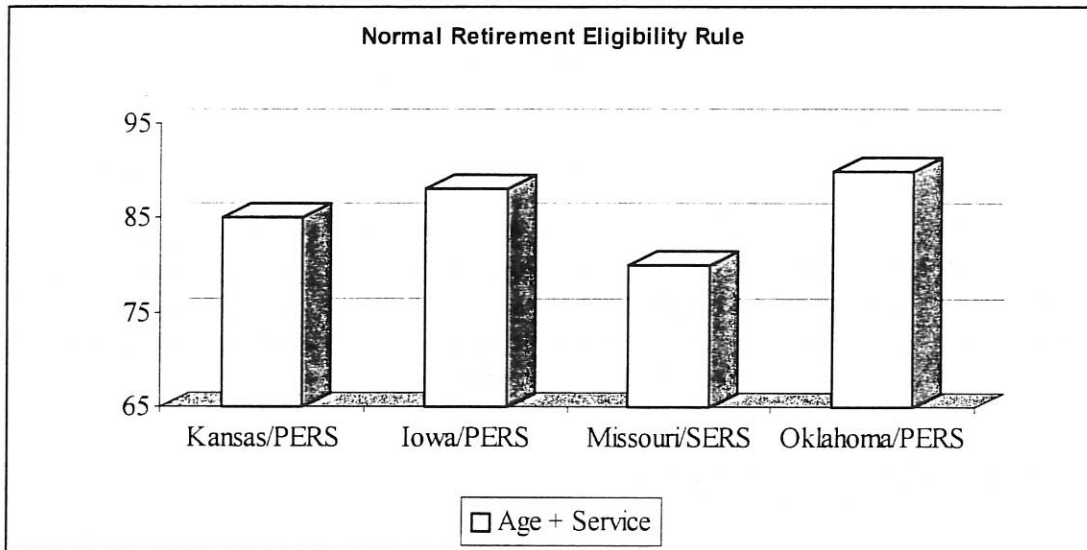
The charts that follow illustrate specific comparison data for the neighboring states of Iowa, Missouri and Oklahoma. We also considered including Colorado and Nebraska. However, Colorado does not participate in Social Security and Nebraska's plan is a defined contribution plan.

The nationwide data is illustrated by showing where KPERS would rank in terms of quartiles. This data includes 43 states that meet the basic criteria indicated above.

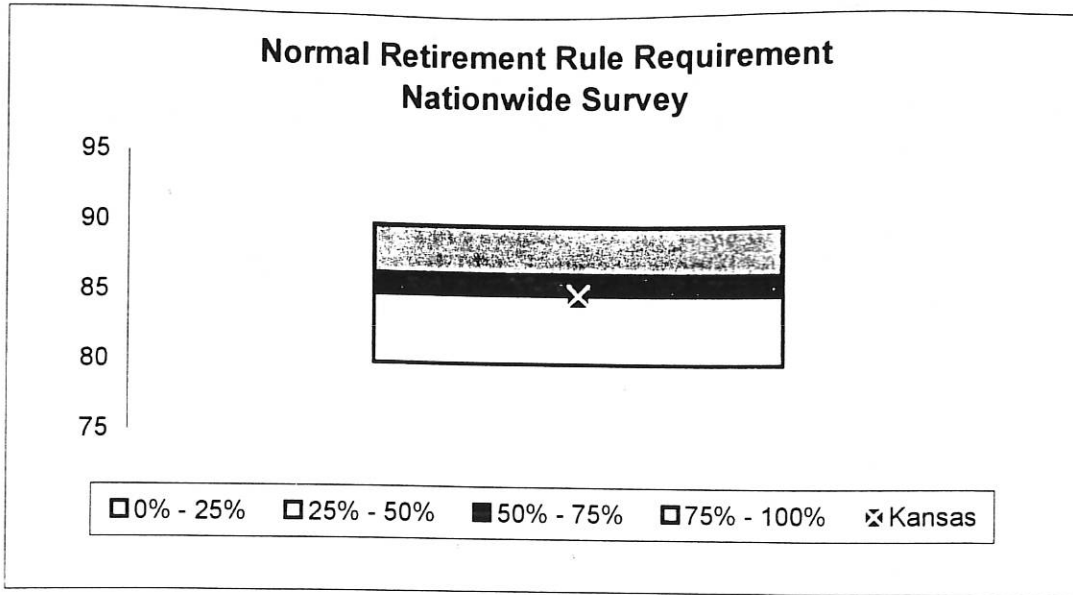
### Normal Retirement Age

KPERS' normal retirement age is age 65. In addition, members can retire with unreduced benefits at age 62 and 10 years of service, or when the sum of age and service equals or exceeds 85. Over half of the states in the survey use age 65 as a normal retirement age, including Iowa and Missouri. (Oklahoma's normal retirement age is 62).

It is also very common to use an age or service rule for normal retirement benefits. The following two charts compared the KPERS' rule of 85 to the rules of other states.

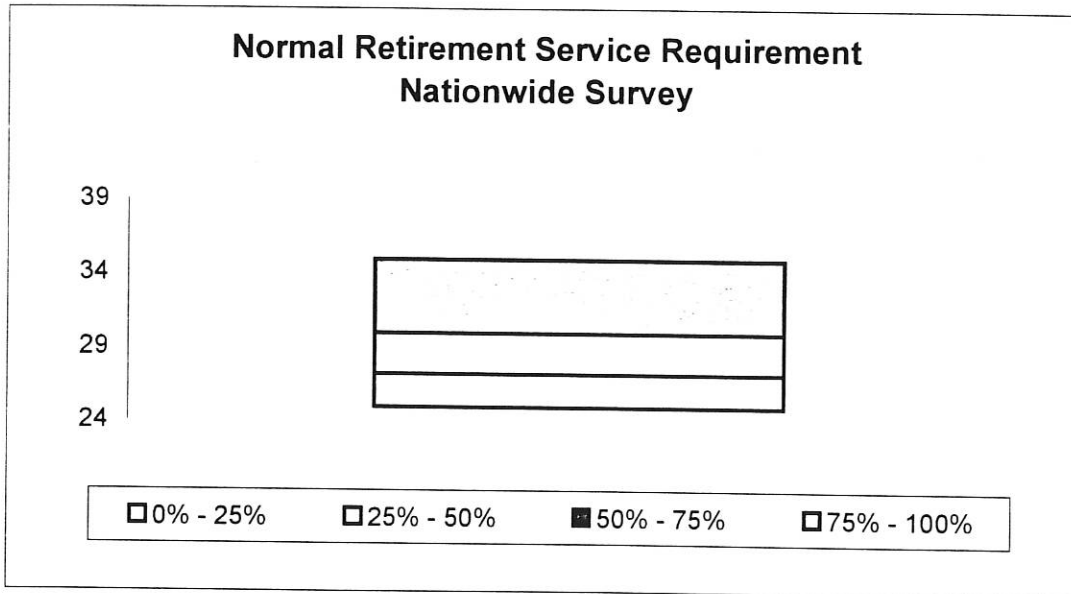


**ANALYSIS OF CURRENT KPERS BENEFITS** *(continued)*



The Rule of 85 for KPERS falls in the middle of both neighboring states and nationwide data.

About half of the systems nationwide (but not KPERS) also permit unreduced normal retirement benefits upon attainment of a period of service. The median period is 30 years as illustrated in the chart below:



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## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

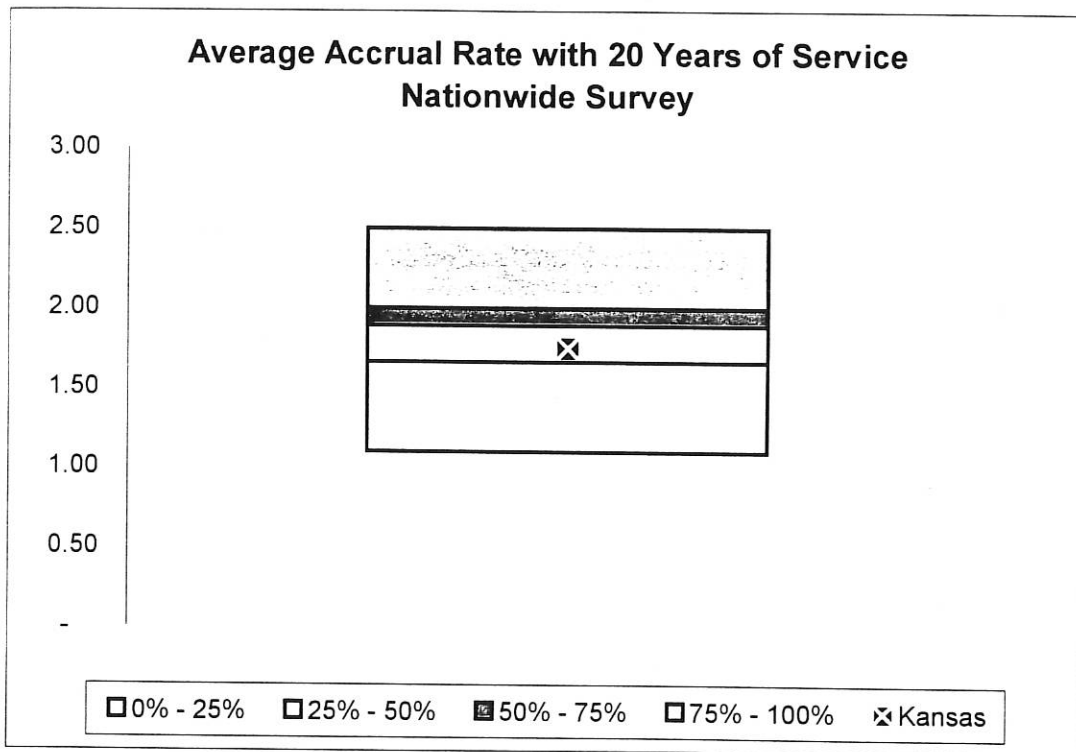
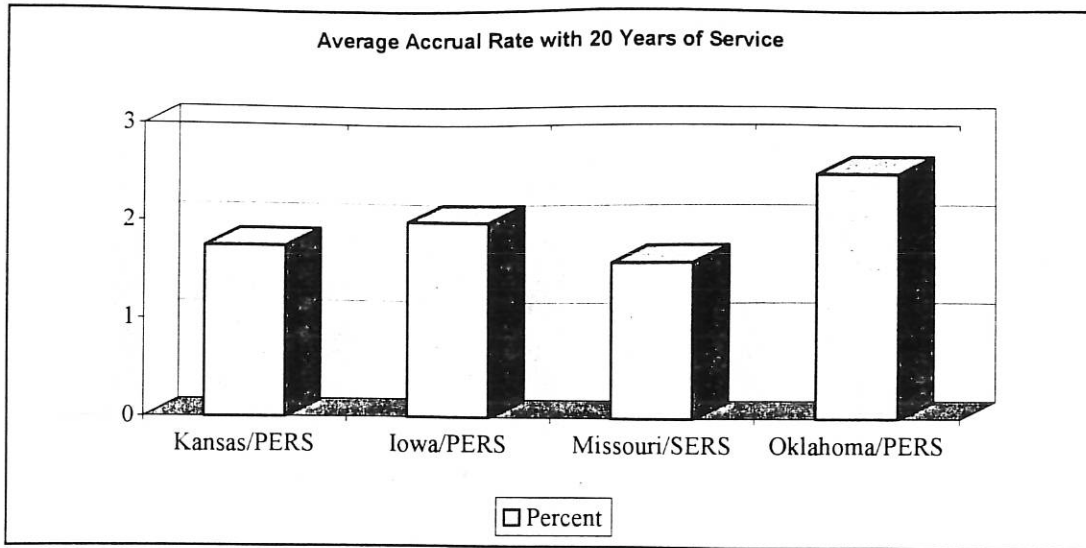
### Benefit accrual rates

Under KPERS, a member receives a benefit at normal retirement equal to 1.75% of final average salary multiplied by participating service. In this formula, 1.75% is referred to as the "accrual rate".

In some states the benefit accrual rate is not constant for all years of service. Therefore for purposes of the comparisons, we have calculated average accrual rates over the first 20 years of service and over the first 30 years of service.

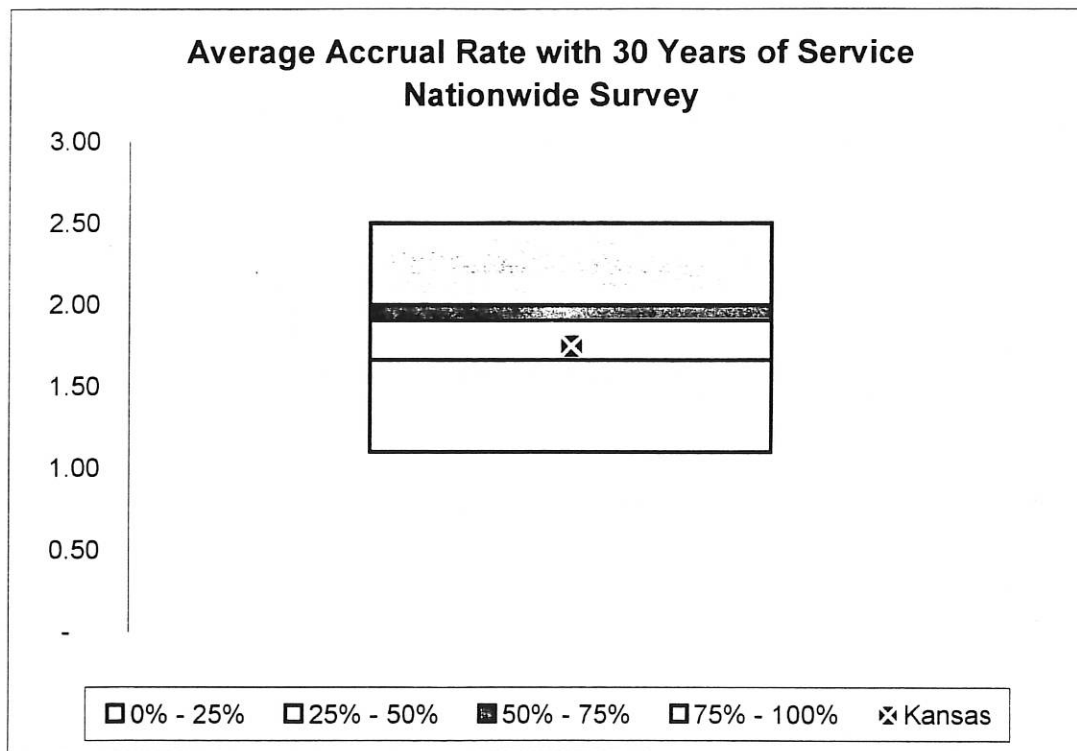
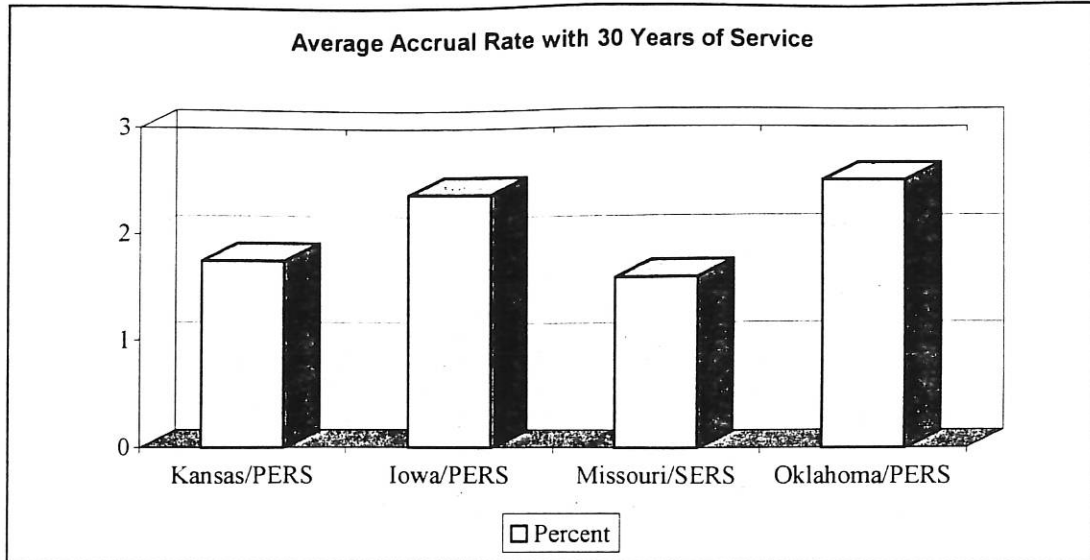
## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

The average accrual rates for the first 20 years of service are shown below for neighboring states and nationwide.



## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

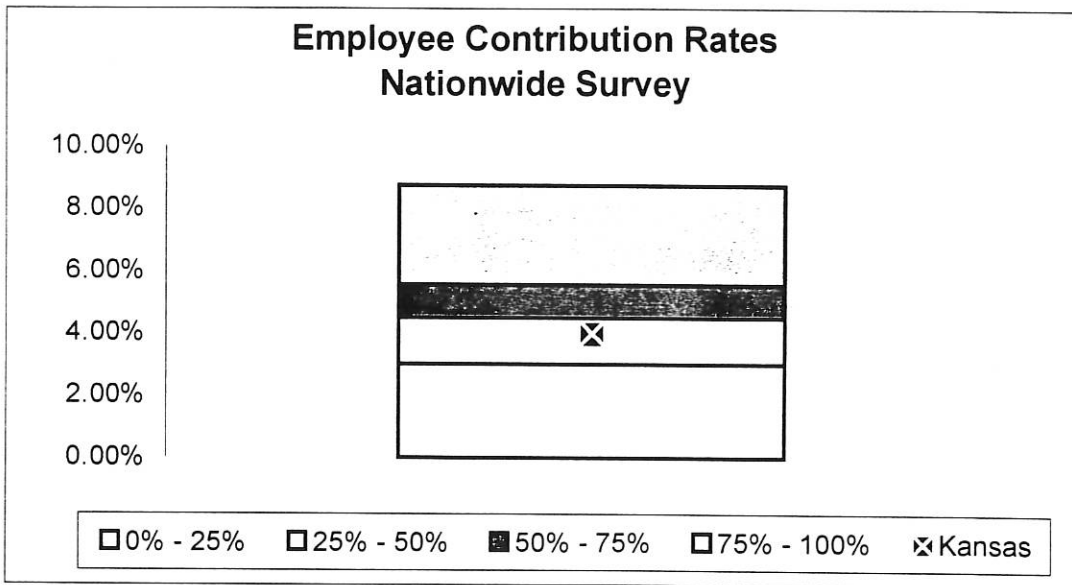
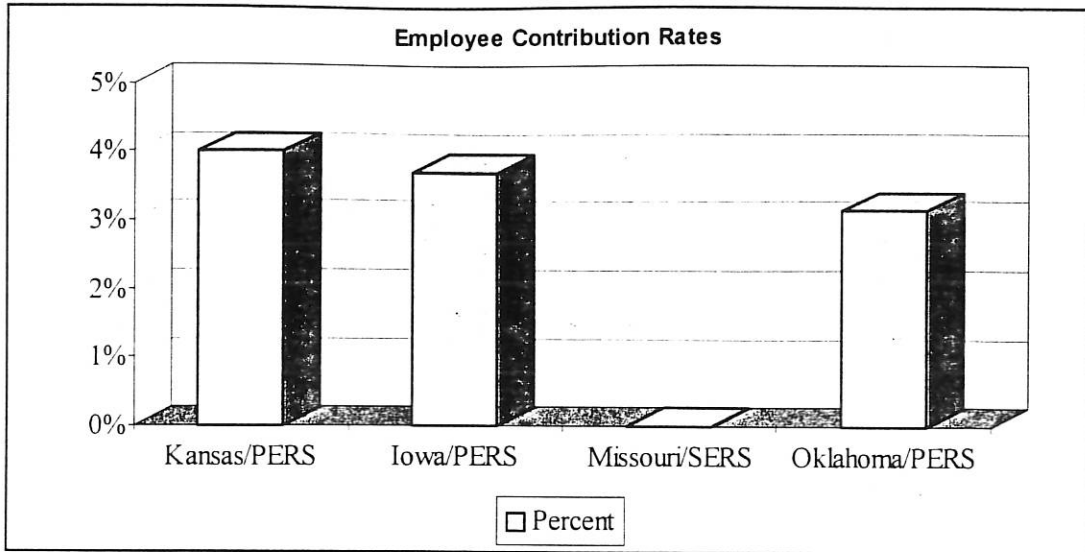
Similar data is presented below based upon accrual rates for the first 30 years of service.



# ANALYSIS OF CURRENT KPERS BENEFITS (continued)

## Employee contributions

Most public employee retirement systems require members to contribute toward the cost of their benefits. KPERS' members contribute at the rate of 4% of salary. The charts below compare this level of contribution to other states.





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## ANALYSIS OF CURRENT KPERS BENEFITS *(continued)*

### Conclusions from comparisons

The following conclusions are drawn from the comparisons to other states:

- The age at which KPERS' members can receive their benefits is comparable to other states.
- The average benefit level in KPERS is somewhat below the median of other states.
- KPERS members contribute more than those in neighboring states, but less than the median for the nationwide comparison.

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### III. POLICY STATEMENT REGARDING INITIAL INCOME REPLACEMENT OBJECTIVES

The following principles are suggested as a policy statement regarding initial income replacement objectives under KPERS

1. The overall goal for income replacement at retirement for a career employee should be in the range of 70% to 80% of pre-retirement income.

Comment: This goal is generally met for career employees who retire after age 62 when Social Security is payable. For career employees who retire prior to age 62 there is a shortfall between retirement age until age 62. Some public systems provide for a supplemental monthly pension between retirement age and age 62.

2. The term "career employee" shall mean an individual whose sum of age and years of service equals or exceeds 85.

Comment: This definition is consistent with full benefits being payable under the Rule of 85.

3. The overall goal should be attained by a combination of KPERS, Social Security and a reasonable amount coming from the individual's own savings.

Comment: Career employees could probably make up any initial shortfall with a regular planned personal savings program.

4. Guaranteed retirement benefits (i.e., from KPERS and Social Security) traditionally have been important for public employees and should continue to be the primary source of retirement income benefits.

Comment: The current level of replacement ratios from these sources for career employees does not always reach the overall retirement income goal, but provide for a reasonable guaranteed level.

5. Any increases in retirement benefits to meet the target income replacement levels may be either in the defined benefit or in a supplemental defined contribution plan.

6. The cost of any retirement benefit increases should be shared between employers and employees. However, it is also recognized that the current level of actual employer contributions is significantly below the actuarially computed contributions. If a choice must be made in allocating additional funds to KPERS, then the primary goal in employer funding should be to reach the actuarially computed level of contributions rather than providing funding for additional plan benefits.

7. The overall benefit level provided by KPERS should fall within the middle range of benefit provided by similar state retirement systems.

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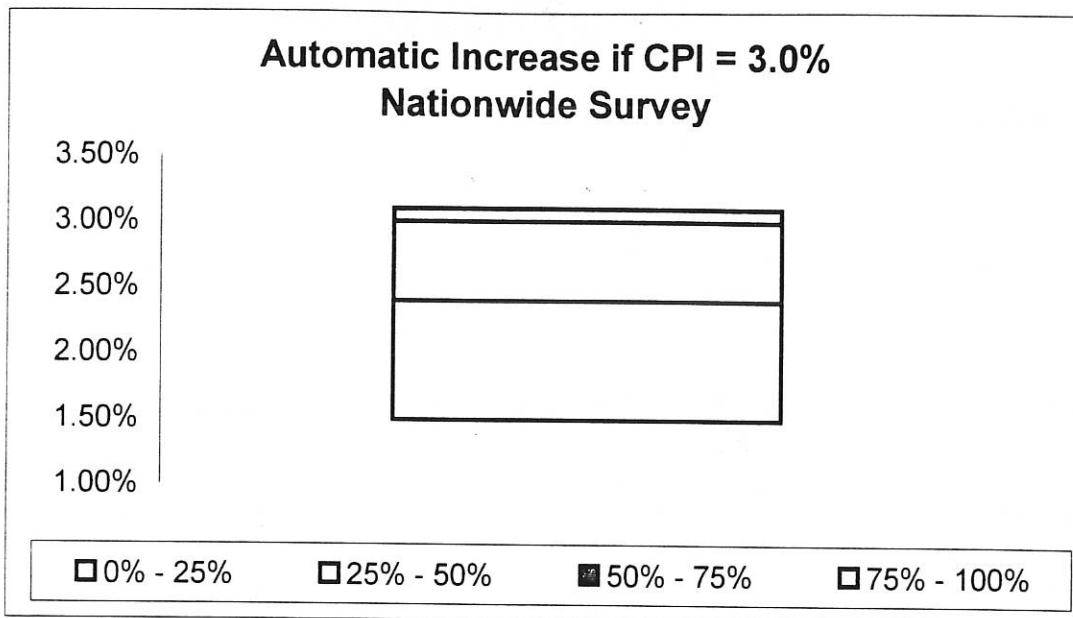
**POLICY STATEMENT REGARDING INITIAL INCOME REPLACEMENT  
OBJECTIVES** *(continued)*

Comment: KPERS' retirement benefits are somewhat below the median of those provided by other states.

8. Employees should understand the role that personal savings plays in providing for retirement security and KPERS should assist them in being able to quantify these goals.

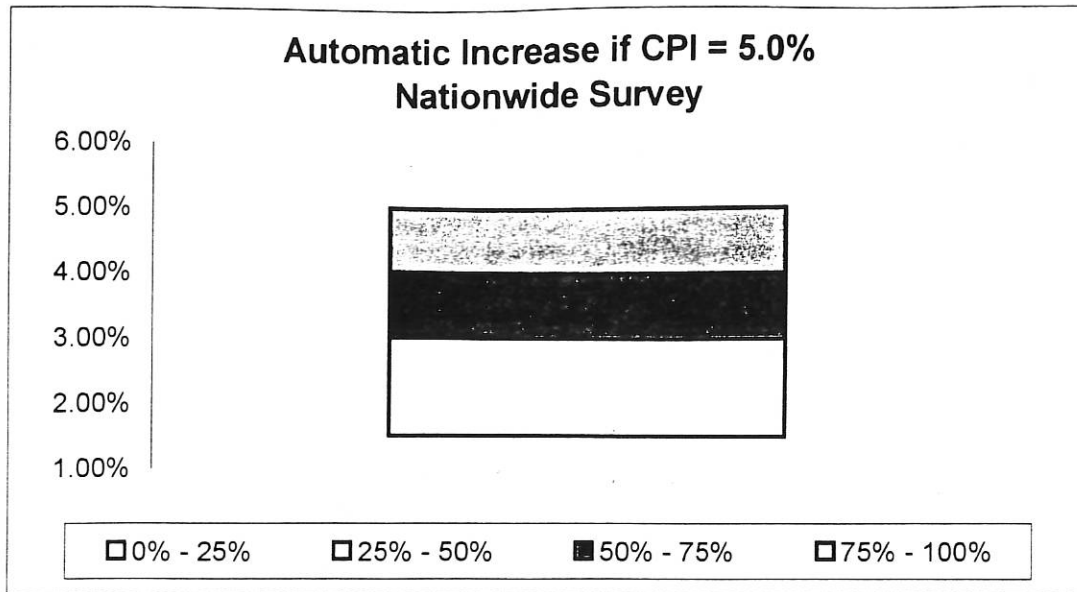
#### IV. ANALYSIS OF COST OF LIVING ALLOWANCES

KPERS does not provide for automatic cost of living allowances, usually referred to as COLAs. Rather, KPERS retirees have received ad hoc increases from time to time, although no such increase has been granted to retirees since 1994. In the nationwide survey approximately two-thirds of the systems provide for automatic COLAs. This fraction is the same for neighboring states, in that Iowa and Missouri provide automatic COLAs and Oklahoma does not. The most typical increase for the automatic COLAs is 3% per year as is illustrated in the two tables below. In the first table we assume an increase in the Consumer Price Increase (CPI) of 3%. In this instance, half of the systems provide for an increase of 3% or more, with the smallest increase being 1.5%.



## ANALYSIS OF COST OF LIVING ALLOWANCES *(continued)*

In the second table we assume an increase in the CPI of 5%. Again, the median increase is about 3%, with the highest being 5% and the lowest being 1.5%.



In determining the extent to which the ad hoc increases for KPERS retirees have kept pace with inflation, we have measured these increases against the CPI over similar periods. The CPI has been the most widely used measure of inflation for the US economy. Whether it is an accurate indicator of the decrease in purchasing power has been a matter of debate for years among economists. The most popular theory is that the CPI may overstate inflation by about 1%. Determining the validity of this theory is beyond the scope of this study. Therefore, we are presenting the comparison of the ad hoc KPERS increases to both CPI and to CPI minus 1%.

## ANALYSIS OF COST OF LIVING ALLOWANCES *(continued)*

The following table shows the average CPI and CPI minus 1% over the last five to twenty-five years, compared to the average increase for a KPERs retiree who had been a retiree for each of the full periods shown:

Period	CPI	CPI minus 1	KPERs Ad Hoc COLAs
Last 5 years	2.5%	1.5%	0.6%
Last 10 years	2.7%	1.7%	2.5%
Last 15 years	3.3%	2.3%	2.2%
Last 20 years	3.4%	2.4%	2.5%
Last 25 years	4.6%	3.6%	2.4%

In terms of purchasing power, the pensions as adjusted by the ad hoc increases are shown compared to the value that would have been derived by an adjustment equal to the full CPI or CPI minus 1%.

	<u>CPI</u>	<u>CPI minus 1</u>
Retired 5 years ago	91%	96%
Retired 10 years ago	98%	108%
Retired 15 years ago	85%	98%
Retired 20 years ago	84%	102%
Retired 25 years ago	58%	74%

## ANALYSIS OF COST OF LIVING ALLOWANCES *(continued)*

In 1993, an average increase of 14% was given to retirees. This increase was given at the same time as benefits were increased for active members and therefore does not necessarily represent an increase only for increased cost of living. If we assume that only 3% of this increase was to cover inflation, then the results from the above two tables would be as follows:

Period	CPI	CPI minus 1	KPERS Ad Hoc COLAs
Last 5 years	2.5%	1.5%	0.6%
Last 10 years	2.7%	1.7%	2.1%
Last 15 years	3.3%	2.3%	2.0%
Last 20 years	3.4%	2.4%	2.4%
Last 25 years	4.6%	3.6%	2.4%

	<u>CPI</u>	<u>CPI minus 1</u>
Retired 5 years ago	91%	96%
Retired 10 years ago	94%	104%
Retired 15 years ago	83%	96%
Retired 20 years ago	83%	101%
Retired 25 years ago	58%	74%

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## ANALYSIS OF COST OF LIVING ALLOWANCES *(continued)*

Our conclusions on the COLA information are as follows:

- While most states provide for automatic COLAs, there are still a significant number that rely upon ad hoc increases.
- The ad hoc increases given to KPERS retirees have generally kept pace with inflation as measured by CPI minus 1%.
- The ad hoc increases in recent years have become much less frequent compared to the years prior to 1994.

### Funding COLAs

In order to estimate the cost of funding automatic COLA's, we have assumed that future inflation as measured by the CPI would average 3% per year and that KPERS would provide an automatic COLA equal to the CPI minus 1%. Therefore KPERS' retirees would expect to receive COLAs averaging 2% per year. There are several options in providing COLAs:

- Automatic COLAs for current and future retirees and beneficiaries  
Using the December 31, 2000 valuation results, we estimate that the addition of this COLA would increase the recommended actuarial funding rate by 3% to 4% of payroll. If the full cost were borne by the employer, the current employer rate of 7.05% (excluding group insurance) for the State/School group would rise to over 10% of pay. (The actual contributions being made are set at 4.58% due to the statutory limit on annual increases). Some of the increased cost might be funded by an increase in the employee contribution rate, which is currently slightly below the median rate for public employee retirement systems. However, any increase in the employee contribution rate should probably be based only on the portion of increased cost related to future retirees (see next point below).
- Automatic COLAs for future retirees and beneficiaries only  
Approximately 30% of the total cost increase is related to currently retired members. Therefore, if the above described automatic COLA provision is limited to currently active members, the increase in the funding rate would be reduced to 2% to 3% of payroll. Again, some of this cost might be funded by an increase in the employee contribution rate. COLAs for current retirees would continue to be granted ad hoc and those costs would be additional.
- Elective automatic COLA for future retirees  
Another option would be to make the automatic COLA feature an optional enhancement. For example, employees could elect to either remain in the current program or convert to a program with automatic COLAs and higher member contributions. If an elective program such as this were established, KPERS should require a minimum period of time for these additional contributions to be made before the automatic COLA would be effective for an individual. Otherwise, employees very close to retirement would be able to receive automatic



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## ANALYSIS OF COST OF LIVING ALLOWANCES *(continued)*

COLAs with very little additional contributions, and the cost to employers would very likely be higher than expected. Current retirees could continue to receive ad hoc increases (with additional cost) but, if so, what should be done about future retirees who did not elect the automatic COLA? Should the legislature exclude them from any ad hoc COLAs as well?

- Automatic COLAs for future retirees for future service only

Much of the cost of providing automatic COLAs is due to an increase in the unfunded actuarial accrued liability relating to service performed prior to the effective date of any COLA legislation. If COLAs were limited only to benefits earned after the effective date, the increase in the actuarial contribution rate would be reduced to about 1% of payroll.

- Ad hoc COLAs

Ad hoc COLAs remain much less expensive to fund than automatic COLAs, at least over the short term. A one time increase equal to 2% for current retirees adds less than 0.2% to the actuarial rate. However, to keep retirees whole with inflation, these ad hoc increases would need to be repeated every year with an additional cost increase resulting in a continually escalating cost scenario.

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## V. POLICY STATEMENT REGARDING POSTRETIREMENT BENEFIT INCREASES

The following principles are suggested as a policy statement regarding postretirement benefit increases:

1. Since fixed pensions have diminished purchasing power over a period of time due to inflation, retiree and beneficiary pensions should be increased over time to reflect these changes in purchasing power.

Comment: The ad hoc increases to date have generally kept pace with inflation.

2. Ad hoc increases should be considered when the cumulative change in inflation since the last increase exceeds 10% to 15%.

Comment: Setting a threshold avoids having a series of many small increases and reinforces the idea that cost of living adjustments are not granted automatically.

3. To reduce the cost of COLA increases, consideration should be given to providing increases to subsets of the total retiree group. This subset may be defined as those retirees who had completed a minimum period of service under the system, or some other definition identifying those retirees to whom the employers feel the greatest obligation.

Comment: As indicated earlier about half of KPERS retirees are not career employees. If dollars are scarce, the state's greater obligation should be to those who invested most of their working lifetime to public service in Kansas.

4. Since the cost of automatic COLA increases would cause a substantial increase in funding cost, this cost should be shared between employers and employees. It is also recognized that the current level of actual employer contributions is significantly below the actuarially computed contributions. If a choice must be made in allocating additional funds to KPERS, then the primary goal in funding should be to reach the actuarially computed level of contributions rather than providing funding for additional plan benefits such as COLA increases.