SESSION OF 2004

SUPPLEMENTAL NOTE ON HOUSE SUBSTITUTE FOR SENATE BILL NO. 260

As Amended by House Committee of the Whole

Brief*

House Sub. for SB 260, as amended, includes a number of provisions addressing public employee retirement benefits, increasing state and local employer contributions, modifying KPERS investment procedures, revising KPERS actuarial procedures for the Kansas Public Employees Retirement System (KPERS), Kansas Police and Firemen's (KP&F) Retirement System, and Retirement System for Judges, and financing for KPERS bonds and enhanced contributions that address the unfunded liability. The bill would:

- authorize a one-time bonus check equal to a one-month benefit payment for all retired members, their beneficiaries, and all disabled members based on a July 1, 2004, eligibility date, to be paid on October 1, 2004.
- provide for the shift of sworn officers in the Capitol Police from KPERS benefits to KP&F benefits.
- provide for the shift of sworn officers in the Motor Carrier Inspection Troop of the Highway Patrol from KPERS benefits to KP&F benefits.
- allow Tier I KP&F members to retire with unreduced benefits after 32 years of service regardless of age.
- exempt certain retired teachers and nurses from the $15,000 cap on annual earnings.
- separate the KPERS state and school group into two separate groups for actuarial calculations and determination of employer contribution rates.

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*Supplemental notes are prepared by the Legislative Research Department and do not express legislative intent. The supplemental note and fiscal note for this bill may be accessed on the Internet at http://www.kslegislature.org

- raise the KPERS local group's employer contribution rate caps to the same levels as the state and school group rate caps.

- increase contributions paid by state and local participating employers for death and disability benefits beginning in FY 2006 for the state and CY 2006 for local units of government.

- adjust the limit on alternative investments but continue to allow only a small percentage of the total portfolio to be invested.

- permit the KPERS staff rather than the Board of Trustees to receive the final due diligence findings on each real estate investment before making the investment.

- allow the KPERS Board of Trustees to establish the actuarial cost method, and to determine the unfunded actuarial liability amortization method and period for all three retirement plans administered by KPERS.

- reimburse the State General Fund for bond payments made on behalf of KPERS and for increased state employer contributions by capping the amount of tobacco funds at $40 million to be transferred to the Children's Initiative Fund, beginning in FY 2008, and directing any amounts above $40 million be transferred to the State General Fund.

Background

SB 260 passed the Senate during the 2003 Legislature and that version of the bill would have authorized issuance of pension obligation bonds. The 2003 Legislature include bond obligation provisions in HB 2014 which was enacted into law last Session.

The House Select Committee on Pensions deleted the original pension obligation bond provisions from SB 260 and added a number of other items into the substitute bill. The following items are included, with original sources noted for other bills incorporated into House Sub for SB 260:

- HB 2012—Allowing earlier retirement for certain Tier I members of the Kansas Police and Firemen's (KP&F) Retirement System (recommended by the Joint Committee on Pensions, Investments and Benefits). The bill would allow Tier I KP&F members to retire with unreduced benefits after 32 years of service regardless of age. Under current law, such individuals who are members of Tier I would have to wait until age 55 for unreduced benefits. A revised fiscal note prepared in 2004 indicated an additional $1.84 million unfunded actuarial liability (UAL) would be incurred under KP&F. The estimated additional first year contributions for the state are $18,725 and for local units are $180,685.

! HB 2500—Modifying limitations on alternative KPERS investments (recommended by the Joint Committee on Pensions, Investments and Benefits). The amended restriction would continue to limit alternative investments to a small percentage of the total portfolio but would allow for greater flexibility in the timing of those investments, thus potentially improving the investment outcome. KPERS would continue to follow a prudent diversification strategy required by statute, utilizing a strategic asset allocation policy designed to maximize returns while mitigating risk. The current asset allocation policy targets five percent of the portfolio for alternative investments. KPERS also would continue to use detailed processes and controls that incorporate statutory requirements to assure that any strategic allocation to alternative investments receives the same level of risk and reward scrutiny as the balance of the portfolio.

Under current law, KPERS alternative investments are limited to five percent of the total portfolio. This bill would remove the five percent limitation and replace it with an annual limitation of one percent of total market value in new alternative investments. Alternative investments are those that are not publicly traded on an exchange. Because they are typically less liquid and potentially more risky than more traditional investments, there have been limits on the percentage of the portfolio that may be invested in this asset class. Over time, the proposed modification is expected to have a positive fiscal impact to the extent that it provides the opportunity for additional investment opportunity and income. The amount and timing of that impact will depend on long-term market conditions.

! HB 2501—Modifying limitations on KPERS real estate investments (recommended by the Joint Committee on Pensions, Investments and Benefits). The bill would allow KPERS staff, rather than the KPERS Board of Trustees, to receive the final due diligence findings on each real estate investment before making the investment. Under current law, the Board of Trustees must receive and consider the due diligence findings on each potential investment before investing in any property. The real estate market's ever-increasing efficiency and liquidity places the current process at a distinct disadvantage. Due to intense competition among institutional investors for quality real estate investments, the closing process (negotiation and agreement to terms) typically moves very quickly. By allowing the Board to provide approval contingent upon the KPERS staff receiving the final due diligence package, KPERS believes the closing process will be expedited and the ability to effectively compete as an efficient buyer will be improved.

! HB 2502—Increasing KPERS, local employer contributions, separating state and school into different groups, and making actuarial adjustments (recommended by the Joint Committee on Pensions, Investments and Benefits). Three major provisions would be implemented:

" Increasing the Local Employer Rate Cap. The bill would increase the KPERS local group employer contribution rate caps to the same levels established for the state and school group by the 2003 Legislature as part of the long-range plan for reducing the UAL. The local group employer rate caps would increase from the current level of 0.15 percent annually to 0.4 percent for CY 2006, 0.5 percent for CY 2007, and 0.6 percent for CY 2008 and subsequent years to insure adequate contributions are remitted. Contributions into the KPERS Fund are expected to increase by the amounts shown in the following table, with corresponding increases in expenditures by local governmental employers. Without employer contribution increases, the KPERS local group's statutory and actuarial rates are not projected to converge, and the group's funded ratio will decline significantly. With the increases prescribed in the bill, the local rates are projected to reach equilibrium at approximately 7.81 percent in CY 2013, and the group's long-term financial health would be maintained. The following table shows the projected impact on local participating employers due to the increase in the rate cap for the first three years:

Projected Impact of Local Employer Rate Increase (in Millions)

Calendar Year	Contributions under Current Law	Increased Rate of Contributions	Amount of Increase
2005	$ 43.05	$ 43.05	--
2006	46.88	50.17	$ 3.29
2007	50.95	59.19	8.24
2008	55.25	70.27	15.03

" Dividing the KPERS State and School Group. The bill would separate the KPERS state and school group into two separate groups—the state group and the school group— for actuarial calculations and determination of employer contribution rates. The State of Kansas would continue to be responsible for making employer contributions for both the state group and the school group. The following table shows the fiscal impact of separating the two groups, compared with a combined state and school group as current law provides. The table only includes retirement benefit contributions and excludes any contributions for death and disability payments. For FY 2033, an estimate of the UAL is based on the December 31, 2002, valuation performed by the KPERS actuary, and figures include the impact of pension obligation bonds. Equilibrium for increasing contributions rates is projected to level off in FY 2018 at 12.3 percent for the combined state and school group, whereas the separate state group would reach equilibrium in FY 2009 at 6.84 percent and the school group would follow in FY 2024 at 15.96 percent.

Projected Impact of Dividing KPERS State and School Group
(in Millions)

FY Contributions	Combined Group	State Group	School Group
2005	$ 172.06	$ 42.55	$ 129.51
2006	200.20	47.42	152.60
2007	228.36	53.43	174.95
Total to 2034	19,800.00	2,900.00	17,700.00
2033 UAL	368.00	23.00	483.00

Note: Projections based on results of 12-31-2002 actuarial valuation, investment returns of 20 percent for calendar year 2003 and a flat 8 percent for calendar year 2004 and beyond, the Entry Age Normal actuarial cost method and a five-year asset smoothing method. Projections do not include changes in the amortization method or period. Includes issuance of $500 million of pension obligation bonds, with $440.2 million proceeds to KPERS. For the split state and school groups, POB proceeds were allocated based on the 12-31-2002 UAL with $20.8 million allocated to state group and $419.4 million allocated to school group.

" Changing Actuarial Methods. The bill would allow the KPERS Board of Trustees to adopt changes in KPERS actuarial methods for the Kansas Public Employees Retirement System, the Kansas Police and Firemen's Retirement System, and the Retirement System for Judges. As reported to legislative committee reviewing KPERS, the Board's intention is to change to the entry age normal (EAN) actuarial cost method for all three systems and to potentially reamortize the UAL for the school group at some optimal point in the future pending actual conditions at that time.

- Actuarial cost method changes. In recent years, both the KPERS consulting actuary (Milliman USA) and an actuary previously retained by the Legislature (William M. Mercer) recommended changes in the actuarial cost methods. Milliman recommended adoption of the EAN actuarial cost method, and Mercer recommended adoption of a single actuarial cost method for all three systems. The EAN method is a cost allocation method used by three-fourths of the state retirement systems. It assumes annual costs are equal to level premiums, expressed as a percent of payroll, needed from the member's entry age until retirement to fund the ultimate retirement benefit. This results in level contributions over time, as a percent of pay.

- Actuarial method and period changes. At this time, the KPERS UAL is amortized over a 40-year period from June 30, 1993. Given the magnitude of the funding shortfall and the benefits of potential reamortization, if this legislation were enacted, the KPERS Board of Trustees would consider reamortizing the school group's UAL at some future date, pending actual conditions at that time. The optimal reamortization date and impact will vary depending on decisions made regarding other funding components such as future employer contributions and pension obligation bond alternatives. Reamortizing the UAL will not reduce the ultimate costs but will extend the time period and level out the required payments to make them more affordable. As with any alternative that defers payments to later years, total costs will be higher with reamortization. The provision should have no fiscal impact for FY 2005 to FY 2008 because it appears the optimal date for reamortizing the school group's UAL will occur near FY 2015.

! HB 2517—modifying working after retirement restrictions for certain teachers and nurses (recommended by the Joint Committee on Pensions, Investments and Benefits). The bill would exempt certain retired teachers and nurses from the $15,000 cap on annual earnings. Under current law, if a KPERS retiree returns to work with the same employer from which he or she retired, the retiree's annual earnings are limited to $15,000. Upon reaching that threshold, the retiree must either stop working to continue to receive KPERS retirement benefits, or continue working and have the benefit payments suspended for the remainder of the year. The bill would eliminate the earnings cap for three specific groups: (a) licensed professional and practical nurses employed by KPERS participating employers, (b) public school teachers who return to teach in hard-to-fill positions in the district from which they retired, and (c) community college teachers who return to teach in hard-to-fill disciplines in the college from which they retired.

The State Board of Education would determine which public school teaching positions qualify as "hard-to-fill" positions and the State Board of Regents would determine the same for community college disciplines. The proposed legislation would require employers to pay both the actuarial employer contributions and employee contributions to KPERS and would sunset on June 30, 2007. Assuming that the KPERS members who qualify for the exemption come from the ranks of teachers and nurses who would have retired absent the bill's provisions, or from those retired in previous years, this bill should have no significant fiscal impact on the KPERS Fund. Employer payments of the employer and member contributions for any re-employed retiree are designed to offset any potential actuarial costs.

In addition, for cases not involving "hard-to-fill positions," the participating employers could determine that a retired, returning teacher or nurse would be subjected to the $15,000 cap and would continue to be governed by the current provisions of law that upon reaching that threshold, the retiree must either stop working to continue to receive KPERS retirement benefits, or continue working and have the benefit payments suspended for the remainder of the year.

! HB 2917—Increasing contributions paid by employers for death and disability benefits (recommended by the House Budget Committee on Tax, Judicial, Transportation and Retirement). The bill would provide that the statutory employer contribution rate for death and disability benefits will increase to 1.0 percent of compensation beginning in FY 2006 for the state and CY 2006 for local units. Under current state law, the rate is equal to 0.6 percent of compensation. Employer contributions to the death and disability fund have been suspended for a total of 14 quarters during the last four fiscal years but are scheduled to return to 0.6 percent for FY 2005.

Absent a rate increase authorized in this bill, the benefits for the death and disability plan will either have to be reduced or eliminated by FY 2006 because the revenue to the plan will be less than the current costs, and the reserves will have been exhausted in FY 2005. The estimated fiscal impact of increasing to 1.0 percent in fiscal year 2006 from the current statutory 0.6 percent rate in FY 2005 would be for the state, from $24.8 million to $42.5 million, an increase of $17.7 million, and for local employers in CY 2006, from $7.2 million to $12.3 million, an increase of $5.1 million. Total employer contributions would increase from $32.0 million in FY 2005 to $54.8 million in FY 2006 and CY 2006, or $22.8 million in additional contributions.

! **Additional Item 1** — Reimbursing the State General Fund for KPERS bond payments and for increased participating employer KPERS contributions authorized to reduce the unfunded actuarial liability. The bill would cap the amount of tobacco funds at $40 million that can be transferred to the Children's Initiative Fund, beginning in FY 2008, and direct any amounts above $40 million to be transferred to the State General Fund. Under current law, moneys from the tobacco settlements are deposited into the Kansas Endowment for Youth Fund (KEY), and transfers are made from the KEY Fund to the Children's Initiative Fund as appropriated by the Legislature. In recent years, some of the money in the KEY Fund has been directed to the State General Fund, rather than to the Children's Initiative Fund, in part to address revenue shortfalls in state taxes.

The House Committee of the Whole added three amendments to the bill. These included:

! HB 2913 – providing for the shift of sworn officers in the Capitol Police from KPERS to KP&F benefits. The bill would provide that on or after July 1, 2004, the Highway Patrol shall affiliate with the KP&F Retirement System to provide future participating service coverage under KP&F for members of the Capitol Police. Following that affiliation, all future sworn officers would become KP&F members, and existing officers could individually elect to join KP&F or remain KPERS members. The Highway Patrol would make employer contributions to KP&F for Capitol Police sworn officers based on the projected state rates. Consequently, the first-year cost of this bill would be the difference between KP&F state employer contributions at 10.06 percent and KPERS employer contributions at 5.47 percent. Assuming all eligible Capitol Area Security Patrol members elected to join KP&F, it appears the FY 2005 cost would be approximately $42,975 in additional contributions. Any officer electing KP&F, or beginning under KP&F, would be required to contribute 7.0 percent of salary, an increase from the KPERS rate of 4.0 percent employee contribution.

- **Additional Item 2** – providing for the shift of sworn officers in the Motor Carrier Inspection Troop of the Highway Patrol from KPERS to KP&F benefits. The bill would provide that on or after July 1, 2004, the Highway Patrol shall affiliate with the KP&F Retirement System to provide future participating service coverage under KP&F for eligible members of the Motor Carrier Inspection Troop. Following that affiliation, all future sworn officers would become KP&F members, and existing officers could individually elect to join KP&F or remain KPERS members. The Highway Patrol would make employer contributions to KP&F for Motor Carrier Inspection Troop sworn officers based on the projected state rates. Consequently, the first-year cost of this bill would be the difference between KP&F state employer contributions at 10.06 percent and KPERS employer contributions at 5.47 percent. Assuming all Capitol Area Security Patrol members elected to join KP&F, it appears the FY 2005 cost would be approximately $116,704 in additional contributions. Any officer electing KP&F, or beginning under KP&F, would be required to contribute 7.0 percent of salary, an increase from the KPERS rate of 4.0 percent employee contribution.

- **Additional Item 3** – authorizing a one-time bonus check for all retired members, their beneficiaries, and all disabled members, to be paid on October 1, 2004. The estimated average monthly check for retired members and beneficiaries is $892 for 58,944 receiving benefits and the average monthly disability payment is $756 with 2,949 receiving benefits. The costs of granting a one-time payment equal to the member's monthly benefit for any person who retired from KPERS, KP&F or the Judges Retirement System, or is receiving disability benefit payments, are summarized as follows, based on the bill which requires amortization over a 15-year period: retirement unfunded liability, total $50.4 million, state $37.7 million, and local $12.7 million. First year costs in FY 2005 are estimated for retirement benefits: total $4,798,000, state $3,676,800 all funds, $3,125,00 SGF, and local $1,121,200. Death and disability FY 2005 costs: total $2,300,000, state $1,783,500 all funds, $1,516,000 SGF, and local $516,500.