Report of the Joint Committee on Pensions, Investments and Benefits to the 2025 Kansas Legislature

CHAIRPERSON: Senator Jeff Longbine

VICE-CHAIRPERSON: Representative Nick Hoheisel

OTHER MEMBERS: Senators Brenda Dietrich, Michael Fagg, Cindy Holscher, and Pat Pettey; and Representatives Bill Clifford, Cindy Neighbor, Tobias Schlingensiepen, Sean Tarwater, Carl Turner, Laura Williams, and Rui Xu

CHARGE

Monitor, Review, and Make Recommendations Regarding the Retirement System

KSA 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, the confirmation of members of the KPERS Board, and the inclusion of city and county correctional officers as eligible members of the Kansas Police and Firemen's Retirement System; and review reports regarding working-after-retirement exceptions (KSA 74-4914 and 74-4937). In addition to its statutory duties, the Committee will consider these pensions matters:

- Implementation of 2024 HB 2711 (working-after-retirement changes; an increase in the lump sum death benefit for KPERS retirees; revision of the statutory cap on alternative investments, KPERS Board investment policy; and the Countries of Concern Divestment Act, requirements on state-managed funds); and

- Possible options relating to KPERS Tier 3 plan design and its overall benefit value (continued study).

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Joint Committee on Pensions, Investments and Benefits

Annual Report

Conclusions and Recommendations

The Joint Committee on Pensions, Investments and Benefits submits the following recommendations:

- **Extraordinary transfer**. The Committee recommends the appropriate standing committees (House Committee on Appropriations, Senate Committee on Ways and Means) consider transferring $1.0 billion from the State General Fund to the Kansas Public Employees Retirement Fund to make an additional contribution toward the reduction of the Kansas Public Employees Retirement System (KPERS) unfunded actuarial liability (UAL);

- **Deferred Retirement Option Program**. The Committee recommends the appropriate standing Committees (House Committee on Financial Institutions and Pensions, Senate Committee on Financial Institutions and Insurance) continue to research and study the Deferred Retirement Option Program, including the advantages and disadvantages of expanding the program;

- **Cost-of-living adjustments**. The Committee recommends the appropriate standing Committees (House Committee on Financial Institutions and Pensions, Senate Committee on Financial Institutions and Insurance) review cost-of-living adjustments (COLAs), including the fiscal impact of implementing a COLA; and

- **KPERS 3 Cash Balance Plan**. The Committee recommends the appropriate standing Committees (House Committee on Financial Institutions and Pensions, Senate Committee on Financial Institutions and Insurance) continue to research and study potential enhancements to the KPERS 3 cash balance plan. The Committee further recommends the costs for any changes to be financed at the time of enactment and not to increase the UAL.

Proposed Legislation: None.

Background

The Joint Committee on Pensions, Investments and Benefits (Committee) was created in 1992 and is authorized by KSA 46-2201 to:

- Monitor, review, and make recommendations regarding 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.

Committee Activities

The Legislative Coordinating Council authorized one meeting day for the Committee during the 2024 Interim. The Committee met on November 20, 2024, to receive reports and updates and hold discussion on the KPERS 2023 actuarial valuation, KPERS budget and pension administration system modernization, pensions obligation bond proceeds, membership and retirement trends, investment performance, and implementation of 2024 law.

Review of KPERS Law and Legislation

A Senior Assistant Revisor, Office of Revisor of Statutes, reviewed legislation pertaining to KPERS: two bills enacted into law in 2024, two bills with legislative consideration, and other KPERS-related bills introduced during the 2024 Legislative Session.

KPERS Bills Enacted into Law

HB 2711 created the Countries of Concern Divestment Act, which requires state-managed funds' divestment from investments with countries of concern, prohibits investments and deposits with a bank or company domiciled in a country of concern, and indemnifies state-managed funds with respect to actions taken in compliance with the Act; amended KPERS working-after-retirement provisions; increased the lump-sum death benefit for a KPERS retiree; and amended law governing the Kansas Public Employees Retirement Fund (KPERS Trust Fund) and investment standards to increase a statutory limitation ("cap") on alternative investments, from 15.0 percent to 25.0 percent, placed on the Board.

Speaking to the bill, the Chief Investment Officer, KPERS, indicated the Board adopted language for the System's Statement of Investment Policy, Objectives and Guidelines in May 2024. The System identified and liquidated 12 securities of 10 companies found to be subject to divestment under the Act, all of which were in Hong Kong or China.

HB 2483 eliminated the requirement for the Legislative Division of Post Audit to conduct recurring audits of the implementation of the 911 system, KPERS audits, and certain economic development incentive audits.

KPERS Bills Receiving Legislative Consideration

HB 2646 would have reopened the closed KPERS 2 plan to certain teachers who will become members on July 1, 2024. The bill would also have provided that teachers who are currently KPERS 3 members would become KPERS 2 members by January 1, 2025.

SB 505 would have increased the benefit multiplier for KPERS-Correctional members to 2.0 percent for any member who retires on or after July 1, 2024. The bill would also have provided for the full payment of the unfunded actuarial liability (UAL) associated with this retirement benefit increase by directing a transfer from the State General Fund (SGF).

Other KPERS Bills Introduced

HB 2563 would have authorized a post-retirement benefit payment of $500 to certain KPERS retirees.

HB 2619 would have expanded the Deferred Retirement Option Program (DROP) to all KPERS members. Under current law, DROP is only available for Kansas Police and Firemen's Retirement System (KP&F) members.

SB 388 would have increased the amount of retiree compensation subject to the statutory contribution rate to the first $40,000 earned by a retiree in a calendar year. This policy was subsequently enacted as part of HB 2711.

SB 396 would have reduced the waiting period for a KPERS retiree to return to work for a participating employer.

SB 502 would have terminated the KPERS 3 cash balance plan and transferred members of such plan to the KPERS 2 plan.

KPERS 2023 Actuarial Valuation Report

The Committee reviewed the latest actuarial valuation, which serves as a snapshot of the financial condition of the Retirement System as of December 31, 2023. The Executive Director of KPERS indicated all membership groups remain at the full actuarial required contribution (ARC) rate, which is a key factor in reducing the UAL and improving funded ratios of each group. [*Note:* This annual actuarial valuation, which measures assets and liabilities, provides the basis for calculating future employer contribution rates.]

The 2023 valuation is used to set the fiscal year (FY) 2027 contribution rates for State/School employers and calendar year (CY) 2026 contribution rates for local employers, and it serves as the baseline for any cost studies performed in the 2025 Legislative Session.

Key Findings

Assets. As of December 31, 2023, the actuarial value of assets totaled $27.6 billion. Actuarial assets are calculated by averaging, or “smoothing,” investment gains and losses over a five-year period. There is a net loss of almost $1.2 billion to be realized in the outlying years. Net investment on a market value basis was 10.6 percent in CY 2023. Due to smoothing, the return on actuarial assets was 6.9 percent.

Funded ratio and unfunded actuarial liability. The Retirement System’s overall funded ratio of assets to liabilities increased from 73.4 percent (2022 valuation) to 74.0 percent. [*Note:* The standards for public pension plans suggest a public retirement system should be funded between 80.0 percent and 100.0 percent of future liabilities owed.] The UAL for the Retirement System increased from $9.6 billion (2022 valuation) to $9.7 billion.

The Executive Director noted that, if all funding assumptions are met in future years, the State/School Group UAL would increase until CY 2028 due to deferred investment losses, after which it would resume declining. Under these conditions, the legacy UAL for the State/School Group would be paid off in the 2039 valuation.

Contribution rates. The report indicated the ARC rates for KPERS State/School employers decrease from 11.68 percent in FY 2026 to 11.32 percent for FY 2027. The statutory employer contribution rate continues to be at the full ARC rate for FY 2027, which will be the seventh consecutive year the statutory and actuarial rates have been equal.

Pension Obligation Bond Proceeds

The Executive Director addressed pension obligation bonds, which serve as a form of arbitrage intended to reduce future employer contributions and improve the solvency of KPERS. Bond proceeds also serve to improve the funded status of the Retirement System. He reviewed the three series of pension obligation bonds the State has issued to date. The first was in 2004 for a total of $500.0 million, gross of fees; the second in 2015 for $1.0 billion, net of fees; and the third in 2021 for $500.0 million, net of fees.

Series 2004C. The 2004 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 million from the Expanded Lottery Act Revenues Fund. As of June 30, 2023, the remaining principal balance was approximately $292 million.

Series 2015H. The 2015 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 million from the SGF. As of June 30, 2023, the remaining principal balance was approximately $857 million.

Series 2021K. The 2021 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 million from the SGF. As of June 30, 2023, the remaining principal balance was approximately $475 million.

Total returns. Average annualized total returns on the Retirement System’s investment portfolio have exceeded the interest cost of all three bond issues. As of August 31, 2024, average annualized total returns were 7.53 percent for 2004C, 7.84 percent for 2015H, and 3.85 percent for 2021K. The value added by the three bond series collectively total approximately $1.1 billion ($658 million for 2004C, $465 million for 2015H, and $20 million for 2021K).

Investment Performance

The Chief Investment Officer (CIO), KPERS, provided an overview of the KPERS Trust Fund performance in FY 2024: a positive return of 9.7 percent, exceeding the actuarial rate of return of 7.0 percent but trailing the policy index, or asset class benchmark, of 11.0 percent. The portfolio's market value increased from $25.6 billion in FY 2023 to $27.3 billion in FY 2024.

The CIO noted the Board regularly conducts asset/liability studies, which are used to establish long-term asset targets. The most recent study was completed in September 2024, and the Board recommended the following targets for the portfolio:

- 23 percent U.S. equity,
- 18 percent international equity,
- 13 percent real return,
- 12 percent real estate,
- 12 percent core fixed income,
- 11 percent private equity,
- 8 percent yield-driven assets, and
- 3 percent cash equivalents.

Fund performance. In the past 3, 5, 10, 20, and 25 years, the portfolio experienced a low return of 3.9 percent for the 3-year average and a high return of 7.7 percent for the 5-year average. Compared with the policy index, or asset class benchmark, the Fund ranges from under-performing by 1.3 percent to outperforming by 0.7 percent for the above time periods.

In FY 2024, the portfolio experienced negative returns on real estate (8.7 percent), largely due to interest-rate-sensitive asset classes that responded to broader market changes. By contrast, the domestic equity portfolio returns were about 23.0 percent as of June 30, 2024.

Economic and market observations. The CIO indicated domestic equity markets have continued to demonstrate considerable strength, closing FY 2024 up 23.0 percent. The CIO noted the market expects the U.S. Federal Reserve to continue easing the Federal Funds interest rate, although further movement will depend heavily on inflation, employment, and economic growth. Other potential influences include the impact of the incoming presidential administration's various policy proposals as well as geopolitical risks that may create short-term volatility.

KPERS Operating Budget and Pension Administration System Modernization

KPERS Operating Budget

The Executive Director of KPERS detailed the KPERS operating budget, which includes general expenses (such as staff, contracts, and office space), investment-related expenses (such as manager fees and investment staff), and administration of the Death and Disability and KPERS 457 programs.

KPERS estimates expenditures totaling $85.8 million in FY 2025 and $92.5 million for FY 2026, the majority of which is financed by the KPERS Trust Fund ($84.4 million and $91.0 million, respectively). General and investment-related expenses compose the largest portion of the operational budget, $32.6 million and $52.0 million, respectively, in FY 2025.

Benefits payments are considered non-expense items for budgeting purposes and are not included when discussing operational expenditures. KPERS estimates total benefits expenses of $2.348 billion in FY 2025 and $2.438 billion for FY 2026.

KPERS Pension Administration System Modernization

The Executive Director outlined the purposes of the pension administration system, which provides the functionality needed to collect data and contributions from employers and to process and pay benefits. KPERS started using its present 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.

In 2020, the Board made the decision to begin the multi-year modernization effort. Additionally, the Legislature authorized a comprehensive 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. In 2021, KPERS used the findings from the assessment to begin establishing requirements for the new system. After an "Analysis and Retool" phase completed by the current contractor, Sagitec, KPERS engaged with Sagitec to gauge the possibility of upgrading the existing system.

In 2022, KPERS determined Sagitec was unable to upgrade the existing system to meet established requirements. Accordingly, the Board approved a request for proposal (RFP) on a new pension administration system.

In 2023, the Kansas Information Technology Office approved the project and KPERS released the RFP for bid. KPERS received two qualified candidates, underwent a review process, and participated in product demonstrations.

In 2024, the Board negotiated contract terms with Tegrit Software Ventures and its Arrivos pension platform. The project has a five-year time frame with a total cost of $74.0 million to implement.

In 2025, KPERS will begin implementation of the new system. KPERS anticipates modernization expenditures totaling $12.0 million in FY 2025 and $14.1 million for FY 2026, all financed from the KPERS Trust Fund. Most expenses will be for contractual services paid to the vendor.

Contemporary KPERS Topics and Issues

Representatives from KPERS provided information on the DROP, the alternative investment cap (HB 2711), proxy voting (2023 HB 2100), KPERS 3 plan design, and cost-of-living adjustments.

Deferred Retirement Option Program

Under the 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 into DROP. 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; currently, the formula allows for 3.0 percent interest in any year in which KPERS investments reach the 7.0 percent investment return assumption.

In 2015, the DROP was created as a five-year pilot program for troopers, examiners, and officers of the Kansas Highway Patrol. In 2019, the DROP was expanded to include agents of the Kansas Bureau of Investigation.

In 2023, HB 2196 expanded eligibility further to include all eligible KP&F members who choose to participate and extended the sunset date to January 1, 2031. The KPERS Planning and Research Officer noted participation in DROP has increased significantly since the program was extended to all eligible KP&F members and employers, nearly doubling since enactment of the bill. As of September 30, 2024, 139 members were enrolled in the DROP.

Alternative Investments Cap

Among its provisions, HB 2711 increases the statutory cap on alternative investments from 15.0 percent to 25.0 percent. Following enactment of the bill, the Retirement System revisited the 2023 Asset/Liability Study, which was completed in May 2023 under the 15.0 percent cap. Accordingly, in May 2024, the Board commenced the Asset Allocation Review Project to evaluate asset allocation strategies available with the increased cap. In September 2024, the Board approved new interim and long-term allocation targets, to be achieved in the next three- and five-plus years, respectively.

The CIO noted increasing the cap allowed the System to set long-term allocation targets and reduce risk while maintaining target returns. The CIO further indicated only a portion of the 25.0 percent cap has been utilized—approximately 19.0 percent of the long-term allocation target.

Proxy Voting

HB 2100 established requirements for a proxy voting advisor and established restrictions on environment, social, and governance criteria for investments. Speaking on implementation, the Planning and Research Officer said the Retirement System's Statement of Investment Policy, Objectives, and Guidelines was updated to align with, and add definitions used but not defined in, the bill, including social, political, or ideological interests.

HB 2100 required engagement of a proxy voting advisor to manage and vote the Retirement System's proxy ballots—a role previously held by investment managers, the CIO noted. Subsequent to enactment of the bill, the Board hired Egan-Jones Ratings Company (Egan-Jones) to vote proxies to its investment managers beginning in FY 2024. Egan-Jones is required to cast proxy votes in accordance with the Retirement System's Proxy Voting Policy, which directs vote recommendations protect and enhance investor wealth.

In FY 2024, a total of 55,229 votes were cast across 8 investment managers. Approximately 2.5 percent of the voting activities were on shareholder proposals, of which approximately half were identified as environmental or social issues. The CIO stated no votes cast by the Retirement System were identified as being in violation of Kansas statute.

KPERS 3 Plan Design

The Planning and Research Officer for KPERS provided an overview of the KPERS Tier 3 cash balance plan. In response to the 2008 recession and a 2011 study commission, the 2012 Legislature created a cash balance plan for members who begin employment on or after January 1, 2015. Differing from KPERS Tier 1 and 2 plan design, the KPERS Tier 3 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 five-year average net compound rate of return above 6.0 percent, as determined by the Board for the calendar year and the four preceding years. [*Note:* Since 2015, the Tier 3 plan serves as the primary retirement plan for new KPERS members. Some employees in corrections positions continue to be enrolled in KPERS Tier 2.]

The Planning and Research Officer indicated KPERS 3 has not been in place long enough to make direct comparisons between KPERS 1, 2, and 3 retirement benefits. Replacement ratios can be used to measure how much of a member's pre-retirement income will be replaced by retirement benefits. Using anecdotal examples, the Planning and Research Officer compared what a member's benefits would be under KPERS 1 and 3.

Speaking on potential solutions, the Planning and Research Officer provided a comparison of general plan design components in defined benefit, defined contribution, and cash balance plans. In particular, he indicated the KPERS 3 cash balance plan design has three components that can be adjusted to enhance benefits: increasing employer credits, increasing interest crediting, and increasing the annuity rates.

The State Treasurer modeled various options to the Committee, noting the costs and benefits of potential adjustments to KPERS 3.

Adequacy from Stakeholders

A representative of the Kansas Association of Chiefs of Police, Kansas Sheriffs Association, and Kansas Peace Officers Association highlighted critical shortages in recruiting and retaining dispatchers and jailers, particularly due to low pay and inadequate benefits. Comparing benefits across KPERS plans, the representative requested an end to KPERS Tier 3 in its current form, preferably with a return to KPERS Tier 2.

A representative of the Kansas Coalition of Public Retirees testified that KPERS 3 is not sufficient, referencing an audit presented to the Legislative Post Audit Committee in February 2024. The representative also praised the provisions of HB 2646, which would have transferred teachers from the KPERS 3 cash balance plan to the KPERS 2 plan. Speaking to potential alternatives, the representative suggested several options, including implementing a Thrift Savings Plan and converting members from KPERS 3 to KPERS 2.

Cost-of-living Adjustments

The Planning and Research Officer provided an overview of cost-of-living adjustments (COLAs), which modify benefits to counteract the impact of economic changes, such as inflation. In 2004, the average retirement benefit was about $10,300. By 2024, the purchasing power of that benefit has decreased to approximately $6,100.

COLAs may be implemented as either an automatic adjustment, occurring on a regular, predetermined schedule, and may be tied to an index such as the Consumer Price Index for all Urban Consumers, or as an *ad hoc* adjustment approved by the plan sponsor or delegated authority. According to the National Association of State Retirement Administrators report of public sector plan COLAs, a selection of 101 plans showed that 74 plans included an automatic COLA and 27, including Kansas', utilized *ad hoc* COLAs.

Adequacy from Stakeholders

A representative of the Kansas Association of Chiefs of Police, Kansas Sheriffs Association, and Kansas Peace Officers Association mentioned that over the course of KPERS' existence, 16 *ad hoc* COLAs were implemented and 5 one-time benefit payments were made to retirees, as well as a 13th benefit check paid to members from 1980 to 1987. The representative compared KPERS benefits with benefits of the Wichita Employees' Retirement System, which has similar benefits in relation to retirement benefit calculations but with an annual 2.0 percent COLA beginning 36 months after retirement.

A representative of the Kansas Coalition of Public Retirees testified that the UAL is the primary reason why the cost of COLAs appears high and is the result of underfunding for 25 years, from 1994 to 2019.

Conclusions and Recommendations

The Committee submits the following comments and recommendations:

- **Extraordinary KPERS payment**. The Committee recommends the appropriate standing committees consider transferring $1.0 billion from the SGF to the KPERS Trust Fund to make an additional contribution toward the reduction of the KPERS UAL;
- **Deferred Retirement Option Program**. The Committee recommends the appropriate standing committees continue to research and study DROP, including the advantages and disadvantages of expanding the program;
- **Cost-of-living adjustments**. The Committee recommends the appropriate standing Committees review COLAs, including the fiscal impact of implementing a COLA; and
- **KPERS 3**. The Committee recommends the appropriate standing committees continue to research and study potential enhancements to the KPERS 3 cash balance plan. The Committee further recommends the costs for any changes to be financed at the time of enactment and not to increase the UAL.