

MEMORANDUM

To: House Committee on Appropriations
From: Alan D. Conroy, ^{APC} Executive Director
Date: March 11, 2016
Subject: House Bill 2725

House Bill 2725 makes changes regarding compensation included in KPERS final average salary calculations, as well as setting new limitations on sick and annual leave benefits.

Background

4-year Final Average Salary Calculation. Final average salary is one of the three components of the formula used to calculate a KPERS member's retirement benefit (final average salary X years of service X multiplier). The 1987 Legislature established that final average salary would be the member's highest four years of salary including add-on pay, which is primarily sick and annual leave. The 1993 Legislature changed the definition of final average salary for all members joining KPERS after July 1, 1993 to the highest three years of salary *excluding* add-on pay. That definition of final average salary is still in effect for all KPERS 1 members with membership dates on or after July 1, 1993.

Due to the potential legal issues associated with changing a vested benefit for existing members, the 1993 Legislature left the four-year final average salary calculation available to members who had entered the KPERS system on or before July 1, 1993 (pre-1993 members). As a result, their final average salary is calculated two ways:

1. The average of the **highest three years** of compensation **excluding** "add-ons" such as vacation and sick leave; or
2. The average of the **highest four years** of compensation, **including** "add-ons."

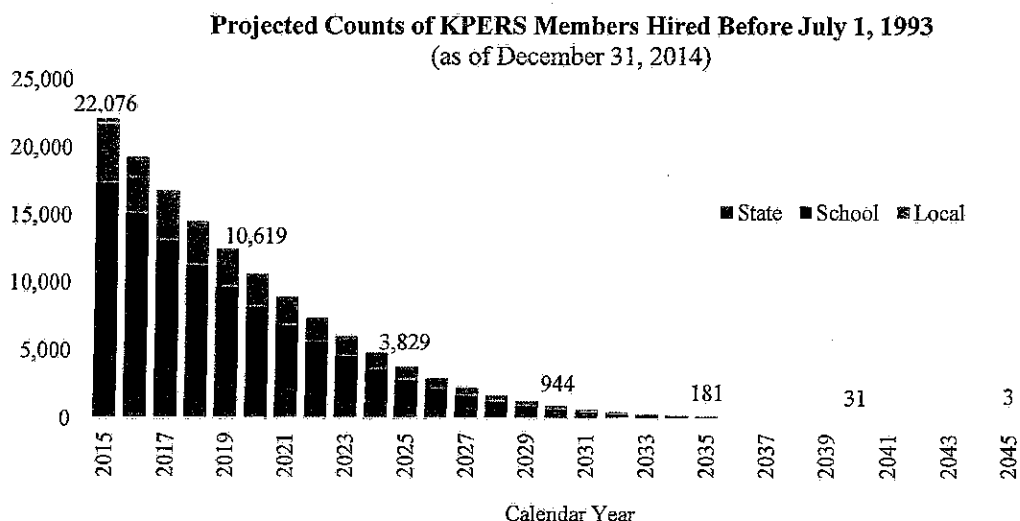
The greater of the two calculations is used in determining the members' retirement benefit.

Therefore, add-ons are not used in the final average salary of all pre-1993 members. Based on KPERS' best estimates, the final average salary for the majority (about 60%) of pre-1993 members retiring in CY 2014 was based on a three-year final average salary **without** add-ons.



As of the most recent actuarial valuation (December 31, 2014), there were 22,076 active members who entered the KPERS system on or before July 1, 1993, which represents about 15% of the nearly 147,000 active KPERS members. Approximately half of those members will be eligible to retire by July 1, 2016.

Using the actuarial retirement assumptions for this closed group of members, that number is projected to decrease by more than 50% in the next 5 years and to fall below 4,000 by 2025.



Based on KPERS' best estimates, the final average salary for the majority of pre-1993 members retiring in CY 2014 was based on a three-year final average salary without add-ons. In CY 2014, approximately 22.5% of all retirees (KPERS, KP&F and Judges) used the four-year final average salary with add-ons, and only about 0.2% of all KPERS group retirees experienced an increase in their benefit exceeding the 15% spiking threshold. Attachment A contains a graphic of the CY 2014 retirement information.

457(f) plans. Both 457(b) and 457(f) plans are recognized by and governed by IRS rules. In general, 457(b) deferred compensation plans are widely available to all or major subgroups of a governmental or non-profit employer's workforce, while 457(f) plans are a legal agreement between the employer and an individual employee. By their nature, 457(f) plans are designed and apply to a small number of very select (usually more highly paid) employees.

Under KPERS' statutory definition of compensation and salary, 457(f) funds received at the end of the contract period are included as compensation for KPERS purposes. However, the IRS caps the amount of compensation on which contributions are made. Moreover, if a member's compensation for any year used in calculating final average salary is more than 15% higher than the preceding year, the amount which exceeds 15% is not included (a lower 7.5% cap applies to KPERS 2 members). This "cap law" limits the effect of a 457(f)

payment. Out of more than 90,000 retirements in the past 20 years, KPERS is aware of two times in which a 457(f) payment was included in final average salary.

HB 2725 Provisions

HB 2725 would apply to KPERS members and explicitly excludes application of its provisions to KP&F members. The bill would have four primary results: (1) establish limits on accrual of vacation leave for all KPERS members; (2) eliminate payment of a portion of accrued sick leave at retirement for all classified and unclassified employees who do not have 100 days of accumulated sick leave on July 1, 2016; (3) limit use of payouts in calculating final average pay for those pre-July 1, 1993 members; and (4) eliminate 457(f) payments from final average salary calculations.

Vacation leave accrual. HB 2725 establishes a hard cap of 240 hours on the amount of vacation time that can be accrued by all KPERS members (State, School, Local), including employees who joined KPERS after 1993. Members above the 240-hour cap on July 1, 2016, would be able to use their accrued vacation leave, but could not accumulate any additional vacation leave so long as the balance remains above 240 hours.

State employee sick leave payouts at retirement. Both classified and unclassified state employees receive payment for a portion of accumulated sick leave balances at retirement, if they have a minimum threshold of 100 days (800 hours) of sick leave. HB 2725 would prevent payment of sick leave at retirement for employees who did not have at least 100 days of sick leave accumulated as of July 1, 2016, effectively ending this benefit for state employees who have not already met that accumulation threshold. This aspect of HB 2725 would apply to all state employees, not only pre-1993 KPERS members.

Limitations on payouts in final average salary of pre-1993 members. HB 2725 limits the inclusion of payouts in final average salary in several respects.

- By virtue of **limiting vacation leave accrual**, lesser amounts of vacation leave would be available for payment at retirement.
 - For purposes of calculating final average salary for pre-1993 members, any accumulated vacation leave as of July 1, 2016, that is in excess of 240 hours could be included in compensation at retirement.
- Likewise, fewer state employees would be eligible to be paid for a portion of their **accumulated sick leave** at retirement. Those eligible would effectively become a closed group, and the benefit would not be available to new state employees or any employee with fewer than eight years of service.
- For a pre-1993 member's final average salary calculation, HB 2725 also **caps sick leave** at the amount accrued on July 1, 2016. Members could accumulate and use additional sick time, but the amount accrued after July 1, 2016, could not be counted as add-on pay for purposes of calculating final average salary.
- Finally, while the intent of this language is not clear, HB 2725 appears to limit the use of add-ons for purposes of calculating final average salary to **only those that were earned within the last four years** of retirement. This provision could be read

as applying to all forms of add-on pay, not just vacation and sick leave payouts at retirement.

- In addition to **limiting the amount of accumulated leave** used in determining the final average salary for pre-1993 members, HB 2725 would **limit the pay rate** that could be used in determining the value of accrued leave.
 - Members would continue to be paid at retirement for the accrued vacation and sick leave based on their current pay rate in accordance with the employer's policies.
 - However, for purposes of valuing the vacation and sick leave used in calculating final average pay, the member's pay rate as of July 1, 2016, is to be used.

Over time, the result of these limitations would be to reduce the number of instances in which the final average salary for pre-1993 members is based on a four-year average with add-ons. Where the four-year average with add-ons does remain higher, the difference between it and the three-year average may be reduced.

457(f) payments. HB 2725 would preclude any payments made to a KPERS member on or after July 1, 2016, under a 457(f) plan from being considered as compensation for purposes of figuring a members' final average salary.

Actuarial Cost Considerations

Payout provisions. 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. By limiting the use and value of vacation and sick leave and other add-ons, HB 2725 would be expected to reduce benefits for some pre-1993 members, and therefore, would tend to reduce KPERS's liabilities. However, KPERS does not have any data regarding members' existing vacation and sick leave balances or the point at which they were earned. Moreover, if HB 2725 is intended to limit inclusion of add-ons earned more than four years before retirement, but paid out at retirement, including compensatory time, no data about compensatory time accruals for KPERS members is available. Therefore, it is not possible to project the actuarial impact of HB 2725.

Some context can be provided by projecting the impact of eliminating use of vacation and sick leave payouts in final average salary calculations for pre-1993 KPERS members. Based on the 12/31/2014 actuarial valuation, KPERS' consulting actuary completed an actuarial cost study evaluating the impact of completely eliminating the use of add-ons in the final average salary calculation. Because HB 2725 would reduce, but not eliminate, add-ons for this closed group, the cost study clearly would overstate the actuarial impact of HB 2725. Moreover, the cost study is based on data that is more than a year old, and due to retirements from this group in the interim, would overstate the impact of such a change.

Totally eliminating use of sick and annual leave was projected to reduce the unfunded actuarial liability (UAL) for KPERS by 0.06% (\$52 million) and a reduction in contribution

rates of 0.19% for the State Group, 0.05% for the School Group, and 0.10% for the Local Group.

A reduction in actuarial required contribution rates would ultimately result in fewer contributions entering the KPERS Trust Fund. However, because the State/School Group statutory employer contribution rate is below the actuarial required contribution rate, only the Local Group reduction would result in reduced contributions through the next several fiscal years.

In both cases, the reduced revenue reflects lower employer contributions required to fund benefits for pre-1993 members. However, HB 2725 would not be expected to result in savings of the amount projected by the cost study, and therefore, the contribution rates would not decline to the extent described above.

Elimination of 457(f) payments from final average salary. Due to the highly infrequent nature of 457(f) payments and the limitations of their impact due to IRS compensation caps and the KPERS "cap law," no material actuarial impact would be expected if such payments were to be excluded from final average pay calculations.

Administrative Cost Considerations

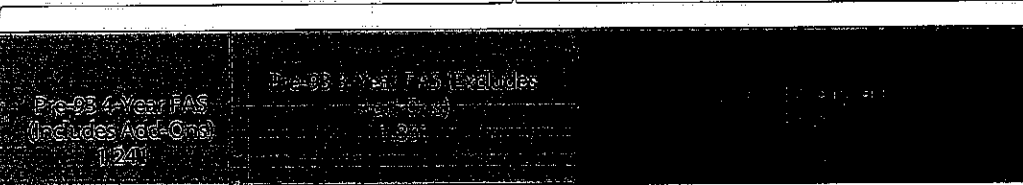
From an administrative standpoint, KPERS currently has neither processes or systems in place to capture or receive data regarding leave balances and pay rates for the more than 20,000 pre-1993 KPERS members as of July 1, 2016, nor the ability to then apply the data in enforcing the limits in HB 2725 at the future point of retirement for each affected member. If add-ons, including vacation and sick leave, can only be included in final average salary calculations if earned in the final four years before retirement, significant additional administrative resources would be required for both KPERS and employers in order to track when the add-ons were earned and used. Modifications to KPERS' information technology system would be necessary to implement HB 2725, but further analysis would be required to more accurately project administrative costs associated with the modifications.

There are questions about the intent of the language in HB 2725 with respect to exclusion of compensation earned more than four years before retirement and application of the pay rate and vacation and sick leave limitations. Therefore, there may be some technical language necessary to clarify the intent so that it is correctly administered.

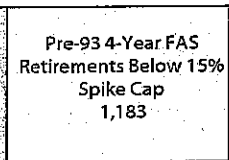
I would be happy to respond further to any questions the Committee may have.

Attachment

5,506 Total System Retirements in CY 2014



Proportion of All Members Retiring in CY 2014 With
Final Average Salaries (FAS) That Included "Add-Ons"
And
Proportion Exceeding 15% "Spike Cap"



Pre-93 4-Year FAS Retirements
Above 15% Spike Cap
58

