MEMORANDUM

To: House Pensions and Benefits Committee

From: Alan D. Conroy, Executive Director

Date: January 27, 2016

Subject: Alvarez & Marsal recommendations regarding KPERS

KPERS was involved in the efficiency study process that is being completed by Alvarez and Marsal on behalf of the Legislature. In their initial report to the Legislature dated January 19, 2016, Alvarez and Marsal made three very **high-level recommendations**, which include:

- Make the required employer contributions to KPERS as specified under current law.
    - For FY 2016, the statutory contribution rate is 10.91%, compared to the actuarial required contribution of 14.95%. This 4.04% gap equates to a funding shortfall of approximately $180 million.
- Encourage KPERS to carry out its Strategic Plan, with emphasis on maximizing investment income consistent with fiduciary responsibility. Currently, KPERS is diligently working to maximize investment income within the guidelines as set by statue and the KPERS Board.
- Consider modest changes in compensation which can be considered in pension calculations. This relates to sick and annual leave add-ons for pre-1993 members and the ability for members to include 457(f) deferrals.

Background information contained in the report did note that KPERS has received favorable grades in a recent CEM Benchmarking Study of KPERS and other peer retirement systems. KPERS received very favorable grades in terms of **providing high quality service to KPERS members at a low cost**.

The efficiency review report also included more detailed recommendations for KPERS, including:

Adopt Policy for Addressing Pension Liabilities:

- In general, KPERS believes that the report's recommendations (adopt a funding policy targeting a 100 percent funded ratio (full funding); commit to fund the full amount of [the actuarial required contribution] for each period; and perform and

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disclose stress test analyses) are consistent with actuarial principles for sound pension funding.

- KPERS supports the development and consistent implementation of a long-term funding policy consistent with actuarial principles.

Leave Payments in Final Average Salary:

- KPERS is available to continue working with the legislature to evaluate this policy, including its actuarial, legal, and administrative aspects.
- The use of leave payments in final average salary is available to a closed and declining group of members
    - As of the most recent actuarial valuation (12/31/2014) there were 22,076 active KPERS members eligible to use add-ons in their final average salary calculation (15% of active KPERS member).
    - Actuarial projections show this group declining to 10,200 by 2020 and 3,800 by 2025.
    - 1,241 (40%) of the 3,092 KPERS members who retired from this closed group in CY 2014 were advantaged by including leave payouts in their final average salary calculation.
- Potential ***actuarial*** savings from excluding vacation and sick leave payments from final average salary calculations are limited as the provision affects a closed, declining group – actual savings would be lower than actuarial projections cited by the report.
    - Data used in those projections is now two years old. Therefore, the projections are overstated, as the size of the closed group would have decreased since the December 31, 2013, valuation on which they were based.
    - The reduction in the unfunded actuarial liability would also be less because eliminating use of add-ons may lead members currently eligible for retirement to retire before the change takes effect.
        - If members retire at a younger age in response to exclusion of add-ons, cost savings noted are diminished as a result of –
        - A faster decrease in the size of the closed group, with fewer members ultimately impacted.
        - The actuarial experience loss that would occur from a spike in retirements occurring before anticipated by the actuarial assumptions (i.e., paying benefits for a longer period of time than expected under actuarial assumptions for these members).
- Due to ***case law*** regarding the contractual nature of public pension benefits, previous legislative changes in the definition of final average salary have been made for future members only or have permitted optional calculations under the prior definition to avoid disadvantaging vested members without a compensating benefit. Similar considerations apply to any further changes to the policy.

- *Administrative* costs are dependent on the way in which changes are structured.
    - Freezing the inclusion of vacation and sick leave at leave balances as of a date certain (HB 2426) is more complex administratively for both KPERS and employers.

Deferred Compensation (457(f))

- Out of 90,000 retirements over the last 20 years, KPERS is aware of no more than 2-3 instances in which 457(f) plan compensation was included in a member's final average salary.
- Due to the highly limited use of this type of benefit, changes would not have a measurable actuarial impact.
- KPERS would view this as primarily a policy issue.
- If modifications are made, consideration should be given to how they are applied to any 457(f) arrangements in existence and any legal issues around changes to existing contracts.

Maximizing Investment Income Consistent with Fiduciary Responsibility

- KPERS believes that its investment philosophy and strategy is consistent with this recommendation.
- The Board just completed its triennial asset/liability study, resulting in a decision to reaffirm and readopt the current long term asset allocation policy targets.
- KPERS has, in the past, sought legislative authority for additional investment flexibility where consistent with this goal, and if similar needs are identified, will bring them to the Legislature.

Repeal Transfer of 80% of Proceeds of Surplus Real Property Sales to KPERS

- While KPERS is supportive of initiatives to enhance KPERS' funded status, this provision has not been a major source of additional funding.
    - Since FY 2013, the KPERS Trust Fund has received approximately $1.2 million from the sale of State surplus property.
- In some instances, other conditions on disposition of proceeds from sale of real property reduce the amount available to KPERS (e.g., federal requirements to return some or all of the proceeds where the property was originally obtained through federal funds).

I hope this information is helpful. Please let me know if there are any additional questions.