House Financial Institutions and Pensions Committee

KPERS Funding, Investments, & Policy - Part 2

PRESENTED BY:

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KPERS

Dependable Benefits. Trusted Partner

KPERS is a fiduciary providing retirement, disability and survivor benefits to our members and their beneficiaries.

KPERS administers three statewide, defined benefit plans for public employees.

- Kansas Public Employees Retirement System
- Kansas Police and Firemen's Retirement System
- Kansas Retirement System for Judges

KPERS partners with more than 1,500 state and local government employers.

- State of Kansas
- 286 school districts
- 105 counties
- 426 cities and townships
- Other employers include libraries, hospitals, community colleges and conservation districts

Covering Today

Actual Funding

Funding Sources

Current Funded Status

Cost of Living Adjustments

Actuarial Funding

KPERS

Purpose of the Annual Actuarial Valuation

Measurement of assets and liabilities

Best estimate of ultimate costs

- Project future benefits using actuarial assumptions
- Calculate present value of future benefits (their cost in today's dollars)
- Apply cost method to allocate benefit costs to periods of service

Calculate employer contribution rates

- The 12/31/2021 valuation sets the contribution rates for FY 2025 for State and School employers and CY 2024 for Local employers.

Baseline for any cost studies in 2023 legislative session

Universal Pension Funding Formula

$$C + I = B + E$$

Contributions + Investments = Benefits + Expenses

"Money In, Money Out"

Funding Sources

KPERS

Employee Contributions

All KPERS covered employees make statutory contributions toward their benefits.

- KPERS members contribute 6% of their pay.
- Judges members contribute 6% of their pay.
- KP&F members contribute 7.15% of their pay.

Employer Contributions

Employers make contributions calculated in the annual actuarial valuation.

The valuation sets employer contribution rates for fiscal years starting two and a half years in the future (e.g. 12/31/2021 set the FY 2025 employer contribution rate).

KP&F and Judges employers are required by statute to make the full actuarial contribution.

KPERS employers are currently paying the full actuarial contribution, but there is a cap on annual increases of 1.2%.

- The KPERS employer contribution rate was less than the actuarial rate for 25 years prior to FY 2021.
- When considering additional contributions and pension fundings bonds, the State has made the actuarial contribution since 2018.

KPERS State and KPERS School pay a combined employer contribution rate, but an individual group rate is also calculated.

FY 2025 Employer Contribution Rates

	Actuarial	Statutory	Shortfall
State	10.66%	11.42%	(0.76%)*
School	11.60%	11.42%	0.18%
State/School	11.42%	11.42%	0.00%
Local	9.26%	9.26%	0.00%
KP&F	23.10%	23.10%	0.00%
Judges	21.35%	21.35%	0.00%

*As provided in statute, the contribution above the State Actuarial Required Contribution (ARC) rate is applied to fund the School Group.

Pension Funding Bonds

The State of Kansas has issued pension funding bonds to improve the funded status of the System on three occasions.

- In 2004 the Legislature approved the sale of $500 million, gross of fees and capitalized interest. These bonds (2004C) were sold at a 5.39% interest rate and KPERS received about $440 million.
- In 2015 the Legislature approved the sale of $1.0 billion, net of fees. These bonds (2015H) sold at a 4.69% interest rate. KPERS received the funding August 2015.
- In 2021 the Legislature approved the sale of $500 million, net of fees. These bonds (2021K) sold at a 2.65% interest rate. KPERS received the funding in August 2021.

All the bond issues are 30-year bonds, and the State pays the annual debt service.

The bond issues are interest arbitrage bonds, which means that over time KPERS' investment returns are expected to exceed the interest rate paid on the bonds, which in turn will reduce required future employer contributions for the State.

Investment Performance as of November 31, 2022

As of November 30, 2022, investment returns on the System's investment portfolio have exceeded the interest cost of both bond issues.

The System's average annualized total return for the time period since the **2004C** bond issue is **7.29%**, compared to the bond interest cost of 5.39%. The value added since issuance, after payment of the debt service, is almost **$469.6 million**.

The System's average annualized total return for the time period since the **2015H** bond issue is **7.33%**, compared to the bond interest cost of 4.69%. The value added since issuance, after payment of the debt service, is about **$278.3 million**.

The System's total return for the two months since receiving the **2021K** bond proceeds is **-4.17%**. This is approximately **$42.3 million** below the interest cost at 2.65%.

The combined investment experience over the time periods since the sale of the three pension funding bond issues is a net positive to the State with **$706 million in value added**. This position is expected to vary over time, depending on market conditions.

Additional Funding

The 2022 Legislature appropriated $1.125 billion in four tranches during CY 2022:

- $553.9 million on May 19
- $300 million on June 1
- $146.1 million on August 1
- $125 million on December 1

Given the extreme market volatility in 2022, spreading the contribution out over four payments reduced the market timing risk.

$253.9 million went toward past employer contributions that had been "layered" in FY 2017 and FY 2019. Those layered payments have now been fully funded.

$871.1 million is additional funding that will help improve the funded status of the System.

All the funding has been received and invested by the System's investment managers.

The impact will be reflected in the next actuarial valuation (CY 2022).

Investments

Most revenue to the KPERS Trust Fund comes from investment returns.

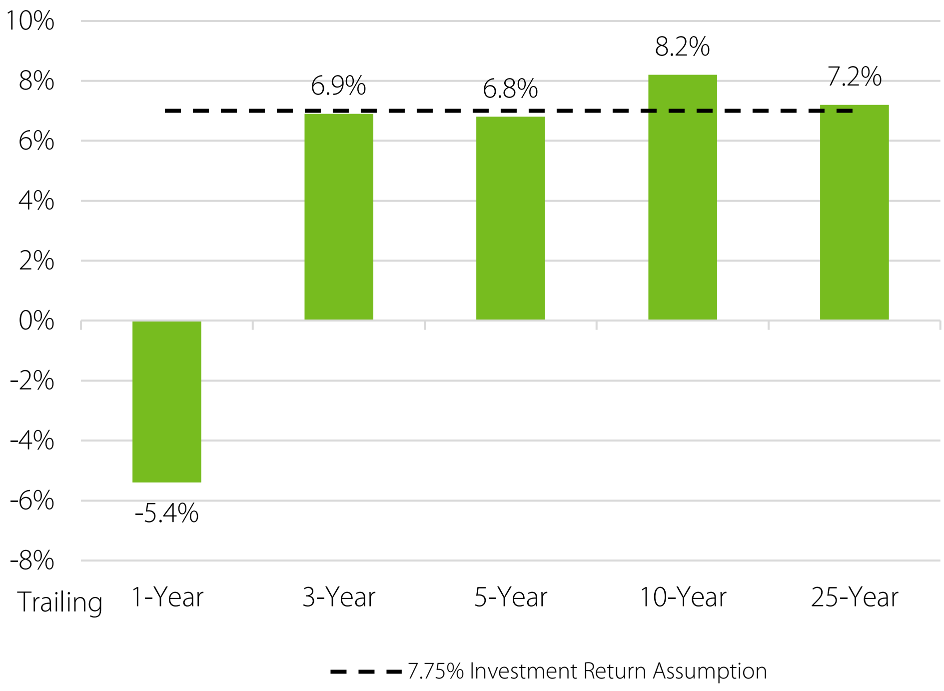
KPERS long-term investment return assumption changed from 7.75% to 7.0% in in May 2022.

CY 2022 was a negative year for investment returns.

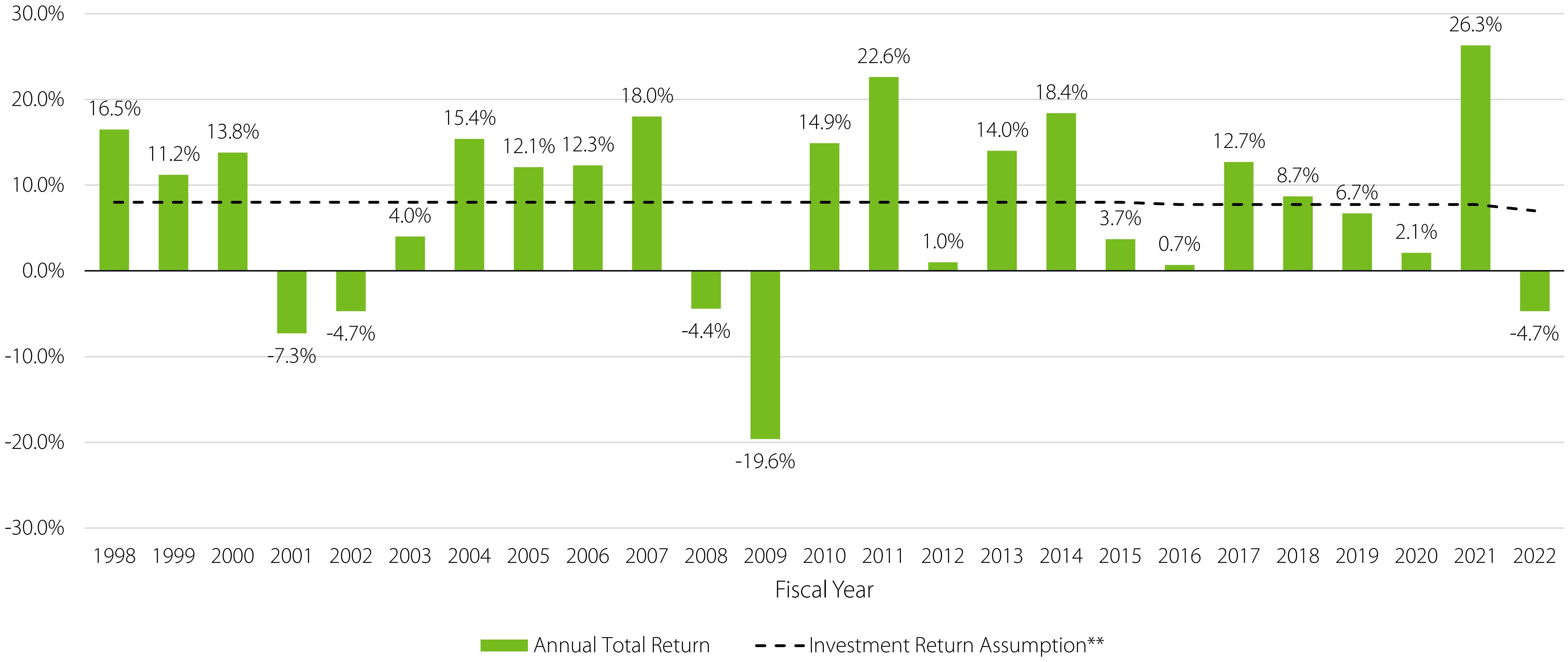
- The CY 2022 total return through November 30 was -7.4%.

Over the past 25-years, KPERS has a total return of 7.2%.

Annualized Total Return through 11/30/2022



Historical Fiscal-Year Returns*



* Time weighted total return, gross of fees

** The investment return assumption was changed to 7.75% on 12/31/2016 and to 7.0% on 12/31/2021.

KPERS Funding Sources

49%
KPERS Investments

35%
Employer Contributions

16%
Member Contributions

Percent of total revenue over 20 years, as of 6/30/2022

KPERS Funded Status

Funded Status on 12/31/2021

As a system, KPERS' funded ratio decreased, and the unfunded actuarial liability increased in the 12/31/2021 valuation.

	12/31/2020	12/31/2021
Funded Ratio	72.5%	71.6%
Unfunded Actuarial Liability	$8.49 billion	$9.83 billion

The change in the funded status is primarily due to an increase in the calculated liabilities due to using a lower investment return assumption (7.0% vs 7.75%). This alone increased the System unfunded actuarial liabilities (UAL) by $2.7 billion.

- State/School UAL increased $1.8 billion
- Local UAL increased $533.8 million
- KP&F UAL increased $327.8 million
- Judges UAL increased $13.7 million

KPERS had a positive actuarial investment return in CY 2021 and additional assets from the $500 million pension funding bond that offset a portion of the increase in the unfunded actuarial liability.

12/31/2021 Unfunded Actuarial Liability (UAL) by group:

	Actuarial Liability (in millions)	Actuarial Assets (in millions)	Unfunded Actuarial Liability (in millions)	Funded Ratio
State	$ 5,081	$ 3,992	$ 1,088	78.6%
School	18,458	12,655	5,804	68.6%
State/School*	23,540	16,647	6,892	70.7%
Local	6,684	4,900	1,784	73.3%
KP&F	4,190	3,050	1,141	72.8%
Judges	217	207	10	95.3%
Total*	$ 34,631	$ 24,804	$ 9,827	71.6%

*Amounts may not add due to rounding.

KPERS Funded Status

Factors affecting the Unfunded Actuarial Liability (UAL)

System Unfunded Actuarial Liability: 12/31/2020	**$ 8,488M**
Statutory contribution cap/time lag*	0M
Amortization (11 years remaining, paying more principal)	(283)M
Experience	
– Investment	(703)M
– Demographics (e.g., number of retirements, wage growth, number of retiree deaths)	107M
– Bond proceeds	(500)M
Assumption changes (7.0% investment return assumption)	2,718M
System Unfunded Actuarial Liability: 12/31/ 2021	**$9,827M**

All employer groups paid the full actuarial contribution in CY 2021 and are projected to stay at the actuarial required amount. The statutory contribution cap is no longer adding to the unfunded actuarial liability.

Note: Amounts may not add due to rounding

*Time lag is the period from the valuation date (12/31/2021) to the date the new contribution rate takes effect – (e.g., 7/1/2024 (FY 2025) for State and School Groups, 1/1/2024 for Local Group) as provided by law.

Funding Projections

If all assumptions were met in future years:

- The State/School group employer contribution rate is projected to slowly decline from 12.57% in FY 2024 to around 8.84% over the next 10 years.
- The State/School group unfunded actuarial liability would steadily decline until the unfunded actuarial liability is paid off in 2039.
- The State/School group funded ratio would reach 80% in the 2023 valuation, 90% in the 2031 valuation and 100% in the 2039 valuation.

We know that not all assumptions will be met exactly each year, but the goal is that the assumptions are accurate over time.

- CY 2022 returns through November were -7.4%.

Cost of Living Adjustments

KPERS

Purpose Cost of Living Adjustment

The value of a fixed pension benefit payment, like KPERS benefits, will erode over time due to inflation.

The longer a member lives in retirement, the larger the total effect inflation will have

A cost of living adjustment, or COLA, is a retirement plan design feature that helps to mitigate the impact inflation has on the purchasing power of benefits.

Cost of Living Adjustment Approaches

Public sector retirement plan designs vary on the inclusion of cost of living adjustments, but generally there are two approaches:

1. **Automatic adjustments**
   Automatic adjustments occur on a regular, pre-determined schedule and require no additional action by the plan sponsor. There may be certain conditions that need to be met (e.g. investment returns). The amount may be tied to an index (e.g. CPI-U) and capped.

2. **Ad hoc adjustments**
   Ad hoc adjustment require approval of the plan sponsor or delegated authority. For Kansas (and most public plans) that is the Legislature. No adjustments are granted without action from the governing body.

As reported by the National Association of State Retirement Administrators, a selection of 100 public sectors plans (state and municipal) showed that 72 plans included an automatic COLA of some kind in the benefit plan design and 28 plans (including Kansas) utilized ad hoc COLAs.

Kansas COLA history

With three exceptions, KPERS plan design has not included a cost of living adjustment since the plan was created in 1961.

1. KPERS 2 included an automatic 2% COLA when it was created in 2007, but that was removed in 2012. As of the 12/31/2021 valuation there were 5 members receiving this COLA.

2. KPERS 3 has a self-funded COLA of 1% or 2%. The member's benefit is reduced at retirement and then grows over time by the selected percentage. The reduction is actuarially equivalent to the base benefit (after option). Five KPERS 3 members have elected the COLA and received an adjustment, the number of members who have elected a COLA since January are being compiled.

3. A 13th check benefit was paid to members from 1980 to 1987, when it was closed to new participants. As of 9/30/2022, 747 members are eligible to receive the 13th check benefit.

No other KPERS, KP&F or Judges members receive automatic cost of living adjustments.

Kansas COLA history

The Legislature has approved both permanent and one-time ad hoc COLAs throughout the history of the plan, including:

- 16 permanent adjustments, most recently in 1998
- 5 one-time benefit payments, most recently in 2008 (applying to members retired at least 10 years)

No cost of living adjustments have been approved by the Legislature since 2008.

As of the 12/31/2021 valuation 11,261 members met the criteria to receive at least one cost of living adjustment since they retired. This represents 10% of the population of retirees and beneficiaries. The remaining 90% of retirees and beneficiaries have never received a cost of living adjustment.

COLA Costs

COLA costs vary widely depending on the characteristics of the COLA.

More Expensive Design

- Built into the plan design (automatic)
- Permanent adjustments
- Compound adjustments
- No eligibility restrictions

Less Expensive Design

- Ad hoc
- One-time payments
- Adjustment to base benefit
- Eligibility restrictions (e.g. years in retirement, retirement benefit amount)

During the 2022 Session, several bills were introduced to implement an ad hoc COLA or an automatic COLA.

COLA Costs

2022 SB 402/HB 2584 was an ad hoc COLA between 1% and 5% depending on number of years since retirement. The adjustment was permanent (paid every year in the future).

The cost to fund the COLA in advance (one-time payment) was $317.4 million.

- For the State/School group, the up-front cost was $229.8 million.

Funded over 15 years, the annual cost was initially $30 million, increasing 3% per year over the 15-year amortization.

- For the State/School group the cost was an increase of 0.41% in the employer contribution rate, which is about $21 million in the first year.

An updated cost estimate of a 3% COLA for all retirees was completed this past fall.

- This applies to more retirees than SB 402/HB 2584.
- The cost estimate is $546 million in a one-time payment or about 0.62% increase in the State/School employer contribution rate for a 15-year amortization ($32 million per year).

COLA Costs

SB 401/HB 2583 was permanent COLA added to the plan design. The adjustment was between 0% and 5% based on changes in the Consumer Price Index (CPI-U).

The one-time cost to fund the increase in the unfunded actuarial liability in advance was $4.9 billion.

- For the State/School group, the one-time cost was $3.3 billion.

Funding the COLA over time requires an increase in the annual employer contribution rate.

- Using a 20-year amortization of the increase in the unfunded actuarial liability raised the State/School employer contribution rate by 4.78%.
- Changing the benefit plan design increases the normal cost of benefits. For the State/School group, the increase in the normal cost was 0.89%.
    - The normal cost increase would be a permanent increase.

The total increase in the State/School employer contribution rate was 5.67%, which is about $253 million in the first year and $260 million in the second year based on current payroll.

COLA Costs

Other cost of living options that have been approved in the past include:

- 13th check payments – Eligible members receive an additional benefit payment during the year.
  - The approximate cost for a one-time 13th check COLA is $156 million.

- One-time additional payment – Eligible members receive a specific dollar amount.
  - In the past, the Legislature has approved one-time payments of $300. The approximate cost for a one-time, $300 payment is $34 million.

The cost of these one-time COLA structures can be adjusted by capping benefits or limiting the eligibility to target the payments to certain groups of retirees.

Questions?