MEMORANDUM

To: House Financial Institutions and Pensions

From: Alan D. Conroy, Executive Director

Date: February 13, 2019

Subject: HB 2197; Amortizing KPERS' State/School Unfunded Actuarial Liability

Amortization of unfunded actuarial liabilities is a normal part of funding a public sector pension plan. Amortization is used to systematically pay off an unfunded liability over a reasonable time period to ensure that the pension plan funding is continually improving. But not over such a long period that there is a generational shift of costs (i.e. future generations paying for past benefits).

House Bill 2197 establishes a new 30-year amortization period for the KPERS State/School unfunded actuarial liability and removes the delegated authority of the KPERS' Board to establish amortization policies for the State/School group. HB 2197 does not make changes to the amortization schedule for the Local group, KP&F or Judges Retirement System.

HB 2197 does not affect retiree benefits or employee contributions.

Current Amortization Policy

The amortization period for the KPERS State/School was initially set by the Legislature in 1993 as a closed 40-year period paid on a level-percent-of-pay. The Legislature chose to delegate amortization decisions to the KPERS Board of Trustees in 1998.

KPERS Board of Trustees has made minor adjustments to amortization policy over the years. The most recent change started in 2016, when the Board adopted a layered amortization method. The existing unfunded actuarial liability at December 31, 2015 continues to be amortized over the remainder of the initial 40 year period (15 years remaining as of December 31, 2018). In addition, this method creates a new 20-year amortization layer each year which reflects the amount of actuarial gain/loss resulting from variations in the actual versus expected experience. If new assumptions are adopted, a separate layer is also created. Each layer has its own payment schedule, and the payments for all of the layers are added together to calculate the total unfunded actuarial liability payment and required employer contribution. This is a relatively new trend for public pension plans, but it has become a "best practice" for the industry. It was recommended by KPERS' consulting actuary during the Board's last review of the amortization policy.

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Recommended Change to Amortization Policy
The FY 2020 Governor's Budget Report included reamortizing the KPERS State/School unfunded actuarial liability. The recommendation includes:

1. Eliminate the remaining 18 payments on the FY 2017 delayed contributions ($6.4 million "layered" payment for 18 years).
2. Eliminate the repayment of FY 2019 delayed contribution ($19.4 million "layered" payment for 20 years).
3. Eliminate the contingent $56 million additional School contributions.
4. Set a new 30-year, level percent-of-pay amortization period as of 12/31/2016 for the State/School unfunded actuarial liability.

HB 2197 accomplishes the policy portions of the recommendation; establishing a new amortization period and eliminating the "layered" payments of the delayed FY 2017 and FY 2019 School employer contributions. Eliminating the $56 million contingent transfer for School group contributions is contained in the FY 2019 Supplemental Appropriations Bill (HB 2121).

Actuarial Cost Projection
KPERS' consulting actuary completed a cost study using the amortization policy and funding changes discussed above. The Governor's proposed amortization has two parts that contribute to the overall cost impact of HB 2197:

1. <u>Reduced assets for valuation purposes.</u> Stopping the scheduled repayment of the delayed FY 2017 and FY 2019 School group employer contributions and eliminating the contingent $56 million additional School contribution in FY 2019 reduces the amount of assets used in the cost projections.

2. <u>Extended amortization.</u> Similar to refinancing the mortgage on a house, extending the amortization period from 15 to 30-years lowers the required contributions in the early years, but increases the overall cost to pay off the unfunded actuarial liability.

<u>Reduced assets for valuation purposes</u>
Because the annual payments on delayed contributions in FY 2017 and FY 2019 are set by statute, those contributions are viewed as an "accounts receivable" and reflected as already being included in the assets for actuarial purposes. Essentially, because those contributions are being paid over time with interest, those contributions are being accounted for in the valuation as if they were already paid.

In addition, current law provides for an additional $56 million contribution in FY 2019, those contributions are also included in the actuarial cost projection.

Eliminating these payments removes them from the actuarial valuation and cost projections which lowers the actuarial assets. This, in turn, decreases the funded ratio and increases the unfunded actuarial liability.

Extended amortization

Extending the amortization period to 30-years on a level-percent-of-pay amortization has long-term fiscal impacts on several levels.

1. Lower contributions in early years
2. Higher contributions in later years
3. Negative amortization
4. Higher unfunded actuarial liability
5. Lower funded ratio

Lower contributions in early years. A level-percent-of-pay funding plan is structured with lower contributions in the first part of the amortization period, but contributions are designed to grow at the rate of payroll. For KPERS the payroll growth assumption is 3% per year. This growth in payments, due to wage inflation, has a significant impact in the dollar amount of contributions by the end of the amortization period.

In the short term, the State/School group actuarial required contribution (ARC) rate for FY 2020 is projected to decrease from 14.74% to 11.45%, a decrease of 3.29%. The estimated reduction in employer contributions due to the decrease in the actuarial required contribution rate is $134.7 million. In addition, elimination of the "layered" FY 2017 and FY 2019 scheduled payments further decreases total contributions in FY 2020 by $25.8 million. The total projected reduction in State/School employer contribution in FY 2020 is $160.5 million.

Higher contributions in later years. The actuarial cost projection for HB 2197 shows projected State/School employer contributions of $521 million in FY 2020, but those State/School employer contributions grow to over $972 million by FY 2049 (assuming 3% payroll growth). Because the new amortization schedule would be making payments for an additional 15 years when compared to current law, the total cost of reamortizing for a 30-year period is projected to be $20.9 billion. This is an increase of $7.4 billion above the projected State/School employer contributions under the current amortization plan ($13.5 billion). Note these contribution amounts are in nominal dollars over a long period so amounts in later years are somewhat inflated.

Negative amortization. By design, a level-percent-of-pay amortization that is 30-years in length is not making the full principle payment on the unfunded actuarial liability in the earlier years of the amortization schedule. This means that the State/School unfunded actuarial liability will grow in the first part of the 30-year amortization period, even if full State/School employer contributions are made and actual returns are equal to the investment return assumption of 7.75%. This is called "negative amortization". To avoid negative amortization, the State needs to contribute at least the interest on the unfunded actuarial liability and the normal cost of benefits. For FY 2020, the total contribution amount needed to maintain a "steady state" and not lose ground on the unfunded actuarial liability is approximately $631 million.

Higher unfunded actuarial liability. Under HB 2197, the State/School unfunded actuarial liability increases initially to $6.8 billion and remains above $6 billion until 2037 before decreasing towards the end of the new 30-year period. The current amortization period has only 15 years remaining and contributions are now starting to reduce the principal of the legacy unfunded liability and are no longer paying only part of the interest. The current State/School unfunded actuarial liability is $6.6 billion and is projected to decrease in every year until it is extinguished in 2035.

Lower funded ratio. Having both a slower contribution schedule and a higher unfunded actuarial liability means that the funded ratio for the State/School group remains lower for a longer period of time.

Generally, a pension system that is below 60% funded is in a position that requires quick corrective action, 60% to 80% is a "cautionary" zone where the funding of the System needs to be monitored to ensure continued improvement, and 80% and rising is considered a stronger position for a pension system. Of course, 100% funded is always the goal for a public pension plan.

The actuarial cost projections for HB 2197 show that the State/School funded ratio under reamortization would remain below 80% funded until 2038, 12 years longer than the projection under current law.

The lower the funded ratio of a pension plan, the more vulnerable it is to negative experience, like a market recession and the higher the probability that adverse experience could severely impact the operation of the System. Conversely, the stronger the funding of the plan, the more able it is to absorb a funding shock due to market conditions.

Attached to this memorandum are graphs that summarize the cost projections for current law and the recommended reamortization.

Reviewing Amortization Options

As the Board nears the end of the existing amortization period on the legacy unfunded actuarial liability, it is normal to review amortization to avoid volatility in employer contributions and to avoid a large "cliff" where required employer contributions drop by a large amount when the unfunded actuarial liability is paid off.

With 15 years remaining on the legacy unfunded actuarial liability, the Board is just now at the point where it will start those discussions. The Board will be reviewing the current amortization policy and methods in 2019.

In addition, amortization recommendations have changed over time and a 30-year closed, level-percent-of-pay amortization method is no longer a recommended practice for public pension plans. The trend is toward shorter amortization periods which more closely match the funding of the system with the demographics of the covered population. Current amortization recommendations are no longer than 25 years, preferably 15-20 years.

The Board of Trustees will be exploring many different options for amortization. As fiduciaries to KPERS members, the Board's focus in any amortization discussion will be centered on what is best for KPERS short- and long-term funding.

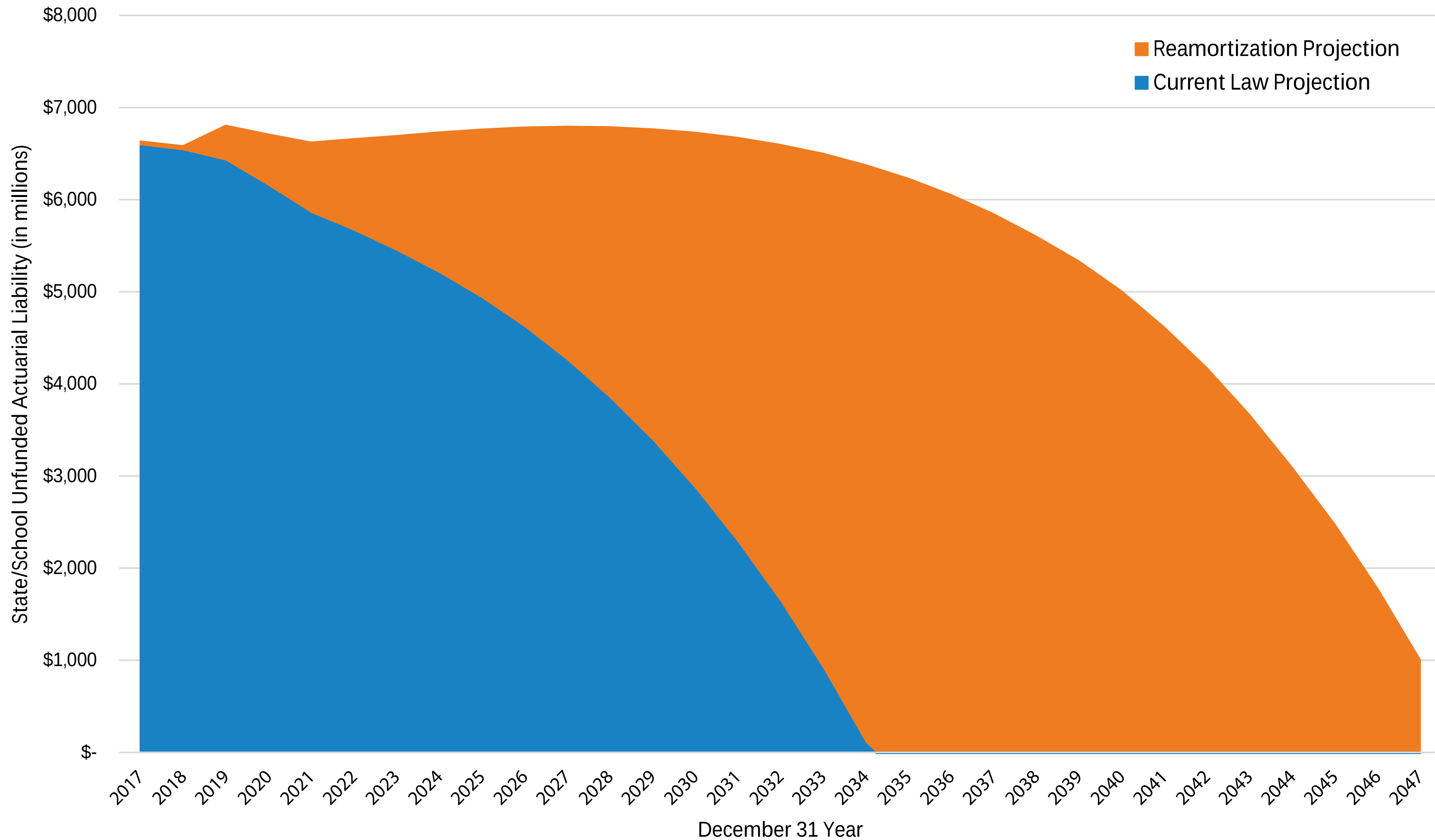
I would be pleased to respond to any questions the Committee has for me.

Attachments

Attachment A

30-Year Reamortization Projection

Reamortizing the Legacy Unfunded Actuarial Liability as of 12/31/2016,
eliminate payment of FY 17/FY19 delayed contributions, and eliminate $56 million contingent payment in FY 2019.
Projected State/School Unfunded Actuarial Liability



The reamortization projection is based on a 30-year amortization (FY 2020-FY 2050) of the legacy unfunded actuarial liability that existed on 12/31/2016. Changes to the unfunded actuarial liability due to actual experience since 12/31/2015 are given an annual 20-year amortization "layer" based on the amortization method approved by the KPERS Board of Trustees as part of the most recent Triennial Experience Study.

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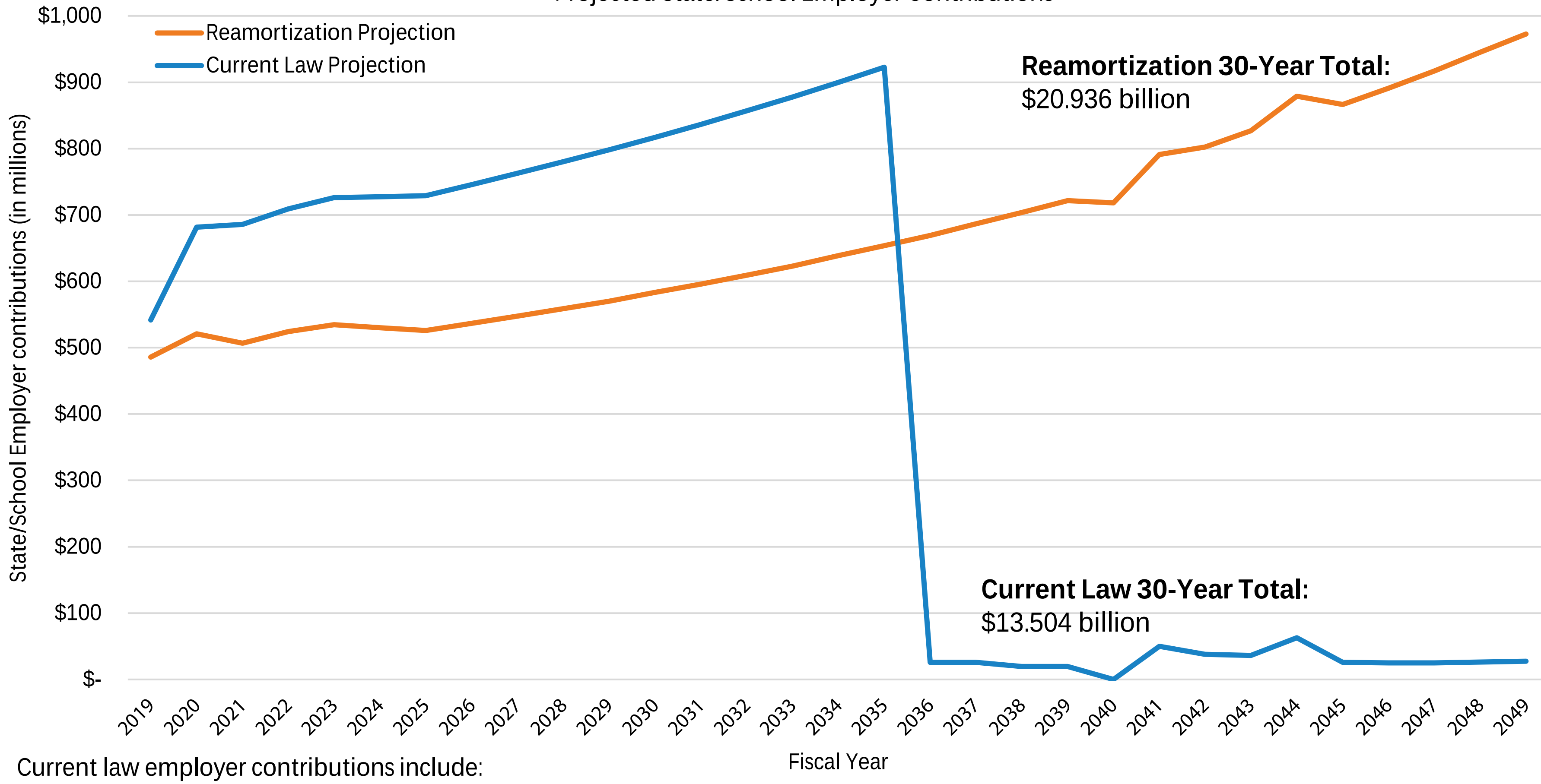
Attachment B

30-Year Reamortization Projection

Reamortizing the Legacy Unfunded Actuarial Liability as of 12/31/2016,
eliminate payment of FY 17/FY19 delayed contributions, and eliminate $56 million contingent payment in FY 2019.
Projected State/School Employer Contributions



Current law employer contributions include:
1. The payment of delayed contributions in FY 2017 ($6.4 million anually from FY 2018-FY 2038) and FY 2019 ($19.4 million from FY 2020-FY 2040).
2. Additional payments of $56 million in FY 2018 (already received), $82 million in FY 2019 (already received) and $56 million in FY 2019 (contingent on actual receipts).

The reamortization projection is based on a 30-year amortization (FY 2020-FY 2050) of the legacy unfunded actuarial liability that existed on 12/31/2016. Changes to the unfunded actuarial liability due to actual experience since 12/31/2015 are given an annual 20-year amortization "layer" based on the amortization method approved by the KPERS Board of Trustees as part of the most recent Triennial Experience Study.

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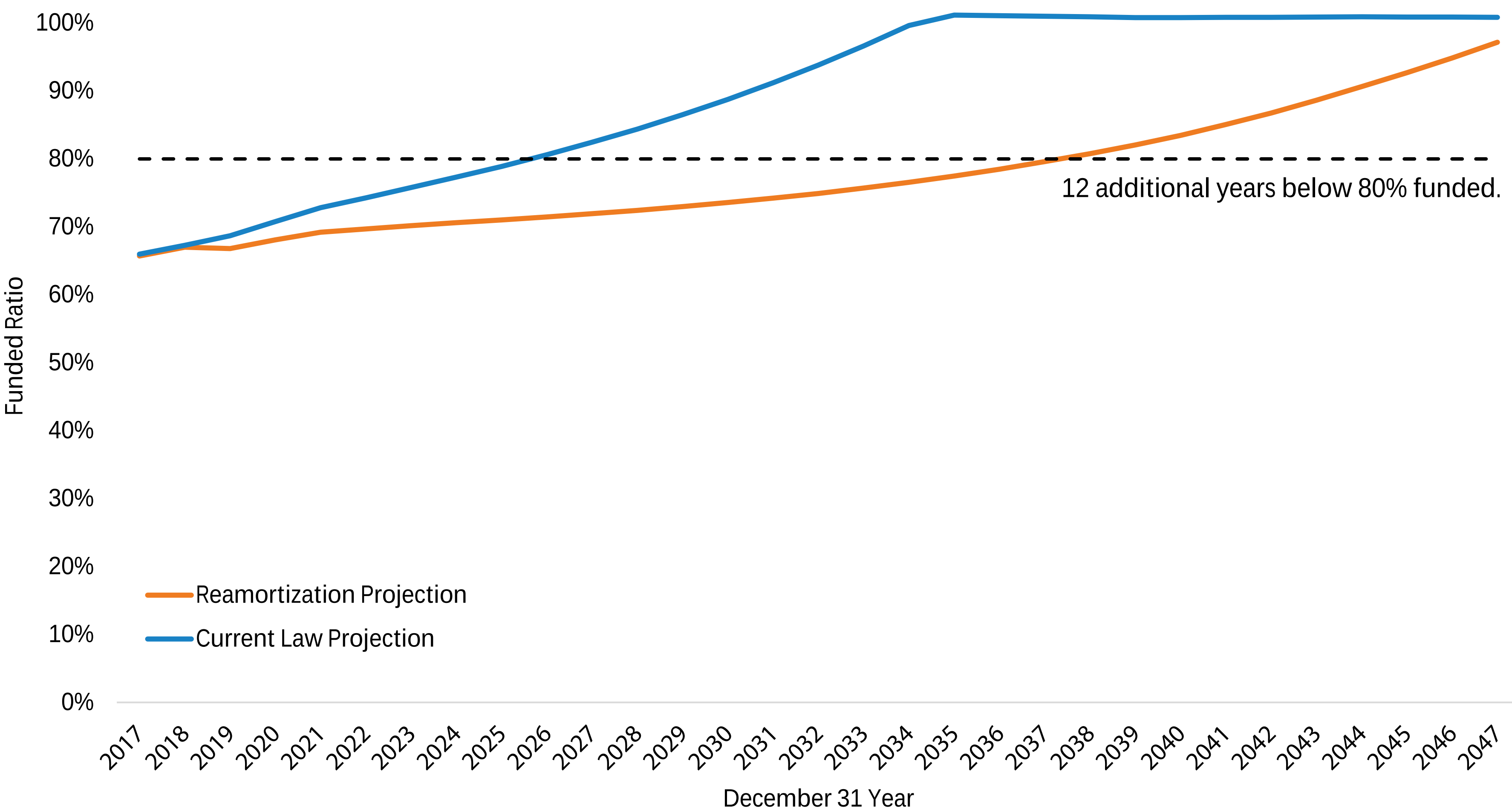
Attachment C

30-Year Reamortization Projection

Reamortizing the Legacy Unfunded Actuarial Liability as of 12/31/2016,
eliminate payment of FY 17/FY19 delayed contributions, and eliminate $56 million contingent payment in FY 2019.
Projected State/School Funded Ratio



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