MINUTES

JOINT COMMITTEE ON PENSIONS, INVESTMENTS AND BENEFITS

December 2, 2020
Room 112-N—Statehouse

Members Present

Senator Jeff Longbine, Chairperson
Representative Steven Johnson, Vice-chairperson
Senator Rick Billinger
Senator Vic Miller
Senator Pat Pettey
Representative Doug Blex
Representative Brenda Dietrich
Representative Broderick Henderson
Representative Jim Kelly
Representative Brett Parker
Representative Rui Xu, appointed substitute member (for Representative Annie Kuether)

Members Absent

Senator Mary Jo Taylor
Representative Annie Kuether
Representative Sean Tarwater

Staff Present

Melissa Renick, Kansas Legislative Research Department
J.G. Scott, Kansas Legislative Research Department
Steven Wu, Kansas Legislative Research Department
Gordon Self, Office of Revisor of Statutes
David Wiese, Office of Revisor of Statutes
Lea Gerard, Committee Assistant

Conferees

Alan Conroy, Executive Director, Kansas Public Employees Retirement System (KPERS)
Justin Stowe, Post Auditor, Kansas Legislative Division of Post Audit
Elizabeth Miller, Chief Investment Officer, KPERS
Jarod Waltner, Planning and Research Officer, KPERS

Others Attending

See Attached List.

ALL DAY SESSION

Welcome and Introductions

Chairperson Longbine called the meeting to order at 10:06 a.m. and welcomed members, staff, and guests to the meeting, as well as Committee members who joined the meeting *via* Zoom conferencing.

Report on "KPERS: Evaluating the Deferred Retirement Option Program" (September 2020)

Alan Conroy, Executive Director, KPERS, provided information on the Deferred Retirement Option Program (DROP) for the eligible Kansas Police & Firemen's Retirement System (KP&F) members in the Kansas Highway Patrol (KHP) and the Kansas Bureau of Investigation (KBI). Under 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- to five-year period. (Members become eligible for DROP based on their age and years of service.) During the DROP period, the member does not earn additional service credits but continues to work and contribute 7.15 percent of compensation into DROP. The KHP or KBI continues to make employer contributions to KP&F. The retirement benefits are held in a separate account and, at the end of the period, the member receives the lump sum with interest and begins receiving retirement benefits. The DROP account can earn interest according to a statutory formula and currently the formula allows for a 3.0 percent interest in any year in which KPERS investments reach the 7.75 percent investment return. The DROP, which was originally created as a five-year pilot program in 2015 (expanded to include certain KBI employees in 2019), has a statutory sunset of January 1, 2025. Mr. Conroy provided a DROP benefit flyer for the Committee members (Attachment 1 and Attachment 2).

In response to questions from Committee members, Mr. Conroy confirmed DROP was created to assist the KHP with recruitment and retention. Mr. Conroy was asked to provide additional enrollment information to the Committee, including the member's choice of the three options available to eligible members. He noted the 3 percent interest is for a calendar year when KPERS investments reach the 7.75 percent# investment return assumption. The DROP was designed to be actuarially neutral and does not have an impact on the unfunded actuarial liability (UAL). He stated the KP&F DROP was created as a pilot program and, if a significant number of people become eligible for the program, the actuary would have to look at the numbers and continue to monitor this impact. Committee members and Mr. Conroy also reviewed the circumstances in which DROP participants would be (*e.g.,* terminating employment) or would not be (*e.g.,* changing from a three-year to five-year option) permitted to elect changes in their DROP arrangement. It was noted if the member withdraws from the DROP program, the accrued benefit is set aside, and any interest earned would be forfeited.

Justin Stowe, Post Auditor, reviewed a performance audit evaluating the DROP, which was authorized by the Legislative Post Audit Committee in April 2020. He noted the audit objective was to answer the following questions:

- How does the Deferred Retirement Option Program affect state agencies?
- How does Kansas' Deferred Retirement Option Program compare to similar programs in other public pension plans?

In response to a question, Mr. Stowe stated out of the retirement-eligible KP&F members surveyed, there were 39 participants in the DROP (35 KHP members and 4 KBI members).

Mr. Stowe then noted the DROP has a very limited number of participants and, out of 7,500 employees covered under the KP&F plan, only KHP and KBI employees are allowed to participate. The cost for the participating employers and KPERS to administer the DROP in its current form is very low and designed to be cost neutral to the KP&F plan. He reported a survey was sent to 111 eligible current and former employees which include both DROP participants and non-participants, and of the 60 responses received, 28 came from DROP participants who acknowledged the program influenced their retirement decision.

Mr. Stowe stated the DROP was shown to be more effective in retaining higher-ranking administrative staff, such as captains and majors, which represent 36 percent of KHP DROP participants. The DROP is less effective for retaining staff in the counties that are understaffed and 8 participants have come from 6 of the 65 understaffed counties KHP initially identified in 2015. He noted the Kansas DROP was compared to four other programs in other states that were designed to be cost neutral to the respective retirement systems with both similarities and differences (Attachment 3).

In response to a question about permitting additional groups to enter the DROP before its sunset, Mr. Stowe stated from an audit standpoint, more data analysis and information in the form of better, uniform data is preferred to make more precise conclusions before extending the program. He stated policymakers would have to balance the need for this recruitment tool within the KP&F membership.

Review of KPERS Legislation Considered During the 2020 Session

David Wiese, Assistant Revisor, Office of Revisor of Statutes, provided an overview of KPERS policy and funding bills that had committee consideration during the 2020 Legislative Session. Mr. Wiese noted no legislation was enacted into law during the shortened session, but the following bills and topics received consideration (Attachment 4):

HB 2452 - provides additional benefits for KP&F tier II member's spouse and children under the age of 18, or under the age of 23 if the child is a full-time student, if the member dies from a service-connected disability. The bill passed the House on final action; was recommended for passage by the Senate Committee on Financial Institutions and Insurance on May 21, 2020; and died on Senate General Orders.

HB 2619 - adjusts the frequency of the KPERS actuarial experience study from once every three years to once every four years. The bill passed the House on final action, 118-7. The Senate Committee on Financial Institutions and Insurance removed the contents of the bill and recommended a substitute bill with financial institutions-related legislation. Senate Sub. for HB 2619 was vetoed by the Governor.

SB 269 - increases the mandatory retirement age for judges to 80 years of age. The bill was amended on January 30, 2020, by the Senate Committee on Judiciary to change the age from 80 to 79 and the effective date from publication in the statute book to publication in the *Kansas Register*. The bill was referred to the Senate Committee on Judiciary on February 3, 2020, and died in committee.

HB 2503/SB 321 - amortizes the State/School KPERS group UAL over a 25-year period; authorizes the transfer of $268,412,000 from the State General Fund (SGF) to the KPERS fund during fiscal year 2020; and eliminates certain level-dollar employer contribution payments.

- **HB 2503** was reported without recommendation by the House Committee on Financial Institutions and Pensions and was subsequently amended by the House Committee of the Whole to remove the reamortization portions of the bill, leaving only the transfer and elimination of the level-dollar contribution payments. The amended HB 2503 passed the House on final action, 125-0, and was referred to the Senate Committee on Ways and Means. The bill had a hearing in conjunction with a hearing on SB 368 on March 11, 2020, and HB 2503 died in committee.

- **SB 321** had a hearing in Senate Ways and Means on February 10, 2020, and no action was taken on SB 321. The bill died in committee.

SB 368 - transfers $268,412,000 from the SGF to the KPERS Fund in fiscal year (FY) 2020 to pay the remaining balance of delayed KPERS State/School employer contributions from FY 2017 and FY 2019. The bill also eliminates the level-dollar employer contribution payments of $6.4 million and $19.4 million per year for 20 years which became statutory obligations after FY 2017 and FY 2019 employer contribution delays. The bill was recommended favorably for passage by the Senate Committee on Ways and Means on March 11, 2020. The bill died on Senate General Orders.

2019 Valuation of KPERS; Update on Performance of Bond Proceeds, 2004 and 2015 Series

In response to a previous question regarding the DROP program, Mr. Conroy stated the breakdown of the 44 DROP participants is 7 selected 3 years of participation, 2 selected 4 years, and 35 selected 5 years.

Mr. Conroy provided an overview of the December 31, 2019, actuarial valuation of KPERS, commenting that, overall, this is great news with several indicators moving in the right direction. KPERS exists to pay for promised benefits to members and their beneficiaries. The agency administers three statewide retirement systems: “regular” KPERS, KP&F, and the Retirement System for Judges (Judges). KPERS serves more than 1,500 state and local government programs (Attachment 5).

Mr. Conroy said the annual actuarial valuation, which measures assets and liabilities, provides the basis for calculating future employer contribution rates. The 2019 valuation is used to set the FY 2023 contribution rates for State/School employers and calendar year (CY) 2022 for local employers and serves as the baseline for any cost studies in the 2021 Legislative Session.

As of December 31, 2019:

- There is a combined total of 156,000 combined active members for KPERS, KP&F, and Judges, and a combined total of 105,000 retirees and beneficiaries.

- Net investments on a CY basis were 17.1 percent (market value). Due to smoothing (averaging), the return on actuarial assets was 6.7 percent.

- The Retirement System's funded ratio of assets to liabilities improved from 68.4 percent (2018 Valuation) to 70.0 percent, remaining below the goal of 80 percent.

- The UAL decreased from $9.2 billion (2018 Valuation) to $9.0 billion. The total actuarial liability is $29.98 billion.

- The actuarially required contribution (ARC) rates for KPERS State/School employers decreased from 14.09 percent in FY 2022 to 13.86 percent in FY 2023. The statutory employer contribution for the State/School group is 14.23 percent in FY 2021 and this contribution is equal to the ARC rate in FY 2021 for the first time in 25 years.

- The Legislature approved additional contributions to KPERS in 2018 and 2019. The additional contributions totaled $304 million over two years with $134 million received for CY 2018 and $166 million received during CY 2019. The funds were directed to the School group UAL but impacted the funding for the State andSchool group. Additional contributions lowered the State/School employer contribution rate by 0.36 percent in FY 2021 and 0.29 percent in FY 2022.

- The total of State/School employer contributions needed to maintain the "steady state" for FY 2021 is $626.2 million.

In response to questions from Committee members, Mr. Conroy stated the Chief Investment Officer will provide information recent investment performance and address market volatility. The State/School contribution rate for FY 2023 is 13.86 percent. Commenting on the combined rate, Mr. Conroy indicated this rate is set by statute and represents a funding choice by the Legislature. It was noted the State and Local rates continue to be at the full actuarial rates. The Committee and Mr. Conroy also discussed the funding projections presented, the anticipated investment experience and overall portfolio assumptions, and the timing of potential future reamortization in relationship to the legacy UAL timeline (2033). Mr. Conroy also confirmed KPERS is not prefunded or designed with periodic cost of living adjustments (COLAs)

Mr. Conroy then provided information on the pension obligation bonds, explaining the bonds are a form of arbitrage intended to reduce future employer contributions and improve the solvency of KPERS. The pension obligation bond proceeds improve the funded status of the Retirement System. Bond debt is considered hard debt and one of the highest budgeting priorities for the State. The first series of bonds issued was in 2004 (2004C) for a total of $500 million, gross of fees, and included approximately $60 million of capitalized interest. The bonds, over a 30-year maturity, pay interest at 5.39 percent. Annual debt is approximately $33.0 million from the Expanded Lottery Act Revenues Fund. KPERS received $440.165 million in net proceeds. The second series of bonds was issued in 2015 (2015H) in the amount of $1.0 billion, net of fees, with proceeds to be deposited in the KPERS Trust Fund. These bonds are 30-year maturity bonds with a total interest cost of 4.68 percent. Annual debt service is approximately $65 million from the SGF (Attachment 6).

Mr. Conroy also addressed investment performance as of September 30,2020, relevant to bond costs and annualized total returns. The average annualized total return for the time period since the 2004C bond issue is 7.13 percent, compared to the bond interest cost of 5.39 percent, adding over $332 million in value to the Retirement System after the payment of the annual debt service. The average annualized total return for the 2015H series is 6.82 percent, compared to bond interest cost at 4.69 percent, adding about $141 million in value to the Retirement System after payment of the annual debt is considered. Mr. Conroy concluded this review by noting as of October 31, 2020, both pension obligation bond series have a net positive to the State with $473 million in value added.

Lunch

The Committee recessed at 11:54 a.m. and was reconvened by Chairperson Longbine at 1:33 p.m.

Update on COVID-19 Pandemic: Impacts on KPERS Operations and Retirements

Mr. Conroy provided information on the COVID-19 pandemic's impacts on operations and retirements, stating KPERS, like all state agencies, was forced into making difficult decisions due to the impact of the COVID-19 pandemic. The previous nine months presented staffing and operations that have required flexibility from staff, employers, and members. In 2020, there has been a bump in the number of retirements compared to prior years. He noted at this time it is unknown how much of the increase is due to COVID-19, but it is a key factor. The number of new applications for retirements and survivor benefits was 1,087 in September and October 2020, compared with 846 retirement applications processed during the same 2-month period in 2019, or an increase of 241 or 28.5 percent. He noted the 28.5 percent increase may have been due to early retirement incentives, a reluctance to return to work or to continue virtual employment during the pandemic, or a lack of actual work (and compensation) for certain school employees. The number of January 2021 retirement applications submitted as of November 23 was 28.9 percent higher than the number submitted as of that same date in 2019. Mr. Conroy further discussed the most significant increase of new retirees was for School group members, which had a year-over-year increase of 185 retirements or nearly 48 percent for the months of September and October. The State group experienced an increase of only 56 retirements, or 12.2 percent. Mr. Conroy then reviewed the other area for which KPERS is seeing a large increase: withdrawal applications. The number of withdrawal payments increased to 3,517 in September and October 2020, 1,756, nearly 100 percent, over the 1,761 payments issued in September and October 2019. Most of the withdrawals are due to financial challenges of the COVID-19 pandemic or may result from an internal project notifying inactive, non-members that accounts are no longer eligible for interest credits. Mr. Conroy indicated it is unclear whether or how long the increases in applications and withdrawals will continue. He also highlighted virtual pre-retirement seminars and efforts to increase remote work opportunities for KPERS staff. In terms of day-to-day operations, Mr. Conroy noted efforts to add plexiglass barriers, focus on remote working, and keep minimum staffing levels on-site. Since November 23, the building has been closed to the public (Attachment 7).

In response to questions from Committee members about Working After Retirement changes to accommodate the pandemic and employer needs, Mr. Conroy stated under the Governor's Executive Order issued last March, if the school employer wanted to hire back a KPERS retiree due to the COVID-19 pandemic, the Working After Retirement waiting period could be suspended through the end of the school year. The number is less than 500 systemwide and mainly within the schools, with some local employers participating (*i.e.*, detention facilities and emergency medical services). Mr. Conroy stated he will provide the actual numbers to the Committee members. When asked about whether legislation was needed to permit the waiver of these requirements in future instances and tolled based on either end of the disaster declaration or school year, Mr. Conroy indicated it would be helpful to have that clarity on authority.

Overview on Investment Performance; Update on COVID-19 Impacts on Investments

Elizabeth Miller, Chief Investment Officer, KPERS, presented an overview of the KPERS investment performance as of June 2020, noting there was high market volatility and low returns. In terms of total fund performance for FY 2020, there was a 2.1 percent total return with a deficit performance benchmark of [-0.3] percent due to equity valuations and market assets. The best performing asset classes for FY 2020 were fixed income, real return, and domestic equity. She stated the current investment environment has massive uncertainty related to the global COVID-19 pandemic and cited both positive and negative indicators present in the economic environment. Ms. Miller also reported the team has been working remotely since March 23 and, in general, the industry has moved to a working-from-home environment. This limits investment manager relationships to general partners and a number of fund raisings (private equity) have been delayed. She also addressed risk mitigation strategies and stress testing scenarios. Addressing a prior question, Ms. Miller reported data as of October 31, 2020, indicates both July and August were positive months with a consistent portfolio index over 3.0 percent and September and October were negative months due to market volatility. For the calendar year to October 31, 2020, the total return is 4.2 percent short of the return on investment. She further noted the S&P 500 was up 11 percent in November and the estimated performance could possibly be around 7.0 percent, which will help the annual valuation for CY 2020 (Attachment 8).

Ms. Miller returned following the discussion of the KPERS Board of Trustees (Board) topic to address a Committee member's questions regarding rebalancing and risk targets and the negative indicators seen in real estate and alternatives.

Overview of KPERS 3 Divident Formula

Jarod Waltner, Planning and Research Officer, KPERS, provided background information on the KPERS 3 dividend credit, which was part of 2012 law creating a cash balance plan. Mr. Waltner explained the cash balance plan is different than the traditional defined benefit plan of KPERS 1 and KPERS 2. The cash balance retirement 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 number of years worked or finalized average salary. The two components of interest that is credited under the cash balance plan are the guaranteed portion and the dividend. The KPERS 3 dividend was originally structured as a discretionary dividend credit that could be provided by the Board. In 2014, enactment of HB 2533 resulted in two adjustments to the interest crediting in KPERS 3 plan design: reducing the guaranteed interest credit rate on the member and employer accounts from 5.25 percent to 4.0 percent and replacing the discretionary dividend credit language with a formulaic dividend design. The current dividend design (KSA 74-49,306) is equal to 75 percent of the 5-year average net compound rate of return above 6 percent, as determined by the Board for each calendar year and the 4 preceding years. Mr. Waltner noted CY 2019 was the fifth year of the KPERS 3 plan and the first year there was a five-year rolling average. The dividend is reviewed by the Board each March and, over the first five years of KPERS 3, the formulaic interest dividend credit has applied twice (Attachment 9).

In response to questions from Committee members, Mr. Waltner confirmed discretionary payments were paid to members of the plan in two years. A member's contributions for the cash balance plan are placed in a trust fund and invested across the portfolio, and the member does not have a choice of investments. It has many similar characteristics of a defined contribution plan and much like a 401K, but still is a defined benefit plan.

Review of KPERS Board of Trustees Priorities

Mr. Conroy presented an overview on the Board activities and noted the Board reviewed possible technical, budget, and policy items during its November meetings. Consistent with Board policies, Mr. Conroy continued, the Board is not recommending any policy changes in terms of benefit enhancements, leaving the decision to the Legislature. The Board has directed KPERS staff to pursue introduction of legislation for a technical update of KPERS guidepost statutes. In addition, it has approved a multi-year modernization of the KPERS pension administration system (Attachment 10).

The Board was advised by Ice Miller LLP, KPERS' tax and compliance counsel, to update the KPERS' Internal Revenue Code guidepost section (KSA 74-49,123) during the 2021 Session to align with the federal Coronavirus Aid, Relief, and Economic Security (CARES) Act provisions pertaining to certain retirement plans. He noted Ice Miller also recommended updating the 457 plan's companion 401(a) plan language in KPERS statutes.

Mr. Conroy then stated the highest priority for the 2021 Legislative Session is the pension administration system modernization. KPERS presently maintains a pension administration system that provides the functionality needed to collect data and contributions from employers and to process and pay benefits. KPERS started using the system in 2005 and, currently, it is 15 years old. He acknowledged the existing system remains capable of providing processes such as collecting contributions and paying benefits but, due to the required customizations over the years, has become less efficient and more unstable over time. KPERS administration and the Board made the decision to begin the multi-year modernization effort with the FY 2021 budget. Mr. Conroy noted the 2020 Legislature authorized the assessment of the system by Segal Technology, which was completed in September 2020. The modernization project will likely extend over four to five fiscal years with a total cost between $20 million and $30 million (from the KPERS Trust Fund). The KPERS budget request for the upcoming budget cycle, Mr. Conroy concluded, includes $11.9 million over two years ($6.6 million in FY 2022 and $5.3 million in FY 2023) for this project.

Discussion and Recommendations for the Committee Report to the 2021 Legislature

Chairperson Longbine reviewed the meeting topics and asked members for recommendations and comments. There was consensus on the following recommendations for the Joint Committee's annual report:

- *Annual valuation report and total fund performance.* The Joint Committee recommends recognizing the outstanding work of the KPERS Board of Trustees and KPERS staff in the continued improvement of the unfunded actuarial liability.

The Joint Committee recommends meeting funding requirements and working with KPERS on their cash position needs to provide certainty and funding. The Joint Committee further recommends to not reamortize prior to the ten-year mark (presently, the Legacy UAL will extinguish in 2033) unless such recommendation come from the KPERS Board of Trustees.

- *Board of Trustees and KPERS administration.* The Joint Committee recommends support of the modernization for the KPERS pension administration system.

- *DROP audit comment and legislation.* The Joint Committee recommends retaining only those eligible employees of the KHP and KBI in the DROP until the current statutory sunset date of January 1, 2025, in order to gain additional information about these participants and allow the Legislature to evaluate the cost and success of the program before considering expansion to other KP&F agencies.

    - The Joint Committee recommends the introduction of legislation that would allow participants to extend their participation; under current law, members are not allowed to change their periods of DROP participation after an initial selection (currently three years, four years, or five years). Further, the Committee requests a fiscal estimate, prior to the 2021 Legislative Session, from the KPERS staff regarding the costs associated with this proposal.

- *Legislation.* The Joint Committee recommends the introduction of legislation to bring the KPERS' Internal Revenue Code guidepost section during the 2021 Legislative Session into compliance with the relevant federal CARES Act provisions and further recommends legislation to update the 457 plan's companion 401(a) plan language in KPERS statutes.

- *Legislation.* The Joint Committee recommends reintroducing HB 2452 that passed the House 125 to 0 and was recommended by the Senate committee in May 2020 (pertains to death and disability benefits, service-connected deaths).

- *Working-after-retirement statutes and emergency management.* The Joint Committee notes its discussion regarding the impacts of the COVID-19 pandemic on KPERS staff and the administration of retirement benefits. The Committee discussed Working After Retirement provisions and the temporary waiver of the required waiting period. As the 2021 Legislature considers the broader topic of emergency management, the Joint Committee notes modifications to KPERS statutes regarding working after retirement should be considered, given the recent waiver of such requirements during the pandemic (*i.e.,* waiting period, opening and closing date, and timing of the expiration date when either the disaster declaration has ended or a school year or semester completes).The Committee notes its discussion regarding whether such potential legislation would only involve only KPERS or is a broader issue of the Kansas Emergency Management Act or Executive Orders of the Governor. There also was discussion, if the decision is KPERS-specific, whether the Legislature, the KPERS Board, or the State Board of Education would have the authority to make the waiting-period change. The Committee discussed providing guidance if a pandemic should occur. The Committee finds clarity and consistency is needed to allow, in such circumstances, certain employers to fill job needs.

- *Retirement System–KP&F Participation.* The Joint Committee recommends urging individual standing committees of the Legislature to continue discussion on possible additions to the KP&F system.

- *Retirement System–Tier 3 Formula.* The Joint Committee recommends the ongoing review of the Tier 3 dividend formula to provide equity as intended.

Adjourn

Following confirmation of the requested legislation to be prefiled, the meeting was adjourned at 3:20 pm.

Prepared by Lea Gerard

Edited by Melissa Renick

Approved by the Committee on:

January 6, 2021
(Date)