MINUTES

JOINT COMMITTEE ON PENSIONS, INVESTMENTS, AND BENEFITS

December 4, 2001
Room 123-S—Statehouse

Members Present

Representative Lloyd Stone, Chairperson
Senator Dave Kerr, Vice Chairperson
Senator Jim Barone
Senator Anthony Hensley
Senator Ruth Teichman
Representative Ray Cox
Representative Geraldine Flaharty
Representative Vaughn Flora
Representative Cindy Hermes
Representative Al Lane
Representative Joe Shriver
Representative Clark Shultz

Staff Present:

Julian Efird, Kansas Legislative Research Department
Alan Conroy, Legislative Research Department
Gordon Self, Revisor of Statutes Office
Mike Corrigan, Revisor of Statutes Office
Carol Doel, Committee Secretary

Committee Conferees:

Stephen McElhaney, Legislative Actuary, William Mercer, Inc.
Glenn Deck, Executive Director, Kansas Public Employees Retirement System
Pat Beckham, Actuary, Kansas Public Employees Retirement System, Milliman USA
Rob Woodward, Chief Investment Officer, Kansas Public Employees Retirement System

Morning Session

Chairperson Stone called the meeting to order and asked for approval of the minutes from the October 23-24 meeting. *Representative Al Lane moved the minutes be approved, seconded by Representative Cox. Motion carried.*

The Chairperson asked to have a document distributed that was prepared by Todd Covault (Attachment 1). Mr. Covault recently completed a research project for post-graduate work on early retirement incentive plans offered by school districts.

Stephen McElhaney, William Mercer, Inc., represented the firm that was retained as the legislative actuary by the Legislative Coordinating Council (LCC), to prepare a post-retirement benefit adjustment study examining the benefits under the Kansas Public Retirement System (KPERS). Mr. McElhaney's report included the results of a study in the following requested areas (Attachment 2):

- Test the KPERS initial income replacement at retirement against income replacement needs of retirees.
- Define an overall benefit policy statement with regard to initial income replacement at retirement.
- Analyze the short- and long-term costs to KPERS and consider alternative financing arrangements to fund the costs associated with benefit increases.
- Develop a policy statement addressing the need for post-retirement benefit increases.

It was noted that inflation influences income replacement after retirement, and a series of projections was provided to demonstrate the influence of inflation on persons retiring under different circumstances. Comparisons of Kansas to other states also were provided, with emphasis on neighboring states. The report was divided into two parts noted below.

Analysis of Current KPERS Benefits. The conclusions presented by the KPERS actuary regarding an analysis of current KPERS benefits cited three items when compared to other states:

- The age at which KPERS members can receive benefits is comparable to other states;
- The average benefit level in KPERS in somewhat below the median of other states; and
- KPERS members contribute more than those in neighboring states, but less than the median for a nationwide comparison.

The legislative actuary's report included a series of recommended policy statement items relative to initial income replacement for retirees.

The Committee took no action regarding the recommendations relative to suggested policy statements. Members of the Committee asked that it be noted that the legislative actuary recommends that "If a choice must be made in allocating additional funds to KPERS, then the primary goal in employer funding should be to reach the actuarially computed level of contributions rather than providing for additional plan benefits."

Analysis of COLAs. Next, the analysis of cost-of-living adjustments (COLAs) presented three conclusions:

- While most state plans provide for automatic COLAs, there are a significant number of state plans that rely on ad hoc increases;
- The ad hoc increases given to KPERS retirees generally have kept pace with inflation as measured by the consumer price index (CPI) minus 1.0 percent; and
- The ad hoc KPERS increases in recent years have become much less frequent compared to the years prior to 1994.

The legislative actuary's report includes a series of recommended policy statement items relative to post-retirement benefit increases. Members of the Committee asked that it be noted that the legislative actuary recommends that "If a choice must be made in allocating additional funds to KPERS, then the primary goal in employer funding should be to reach the actuarially computed level of contributions rather than providing for additional plan benefits such as COLA increases."

The Committee took no action regarding the report and adopted no recommendations relative to suggested policy statements. A final draft report is expected to be delivered in January 2002 that incorporates Committee discussion at the December 2001 meeting.

The Mercer report reviewed post-retirement benefit increases, and one of its goals was to determine the extent to which the ad hoc increases for KPERS retirees have kept pace with inflation. The study measured these increases against the CPI over similar periods. The CPI has been the most widely used measure of inflation for the U.S. economy. Whether it is an accurate indicator of the decrease in purchasing power has been a matter of debate for years among economists. The most popular theory is that the CPI may overstate inflation by about 1 percent. Determining the validity of this theory was beyond the scope of this study. Therefore, the report included a comparison of the ad hoc KPERS increases to both CPI and to CPI minus 1 percent. The following tables are taken from page 23 in (Attachment 2) and are referred to numerous times in the discussions noted in the minutes.

The following table shows the average CPI and CPI minus 1 percent over the last 5 to 25 years, compared to the average increase for a KPERS retiree who had been a retiree for each of the full periods shown:

Period	CPI	CPI minus 1	KPERS Ad Hoc COLAs
Last 5 years	2.5%	1.5%	0.6%
Last 10 years	2.7%	1.7%	2.5%
Last 15 years	3.3%	2.3%	2.2%
Last 20 years	3.4%	2.4%	2.5%
Last 25 years	4.6%	3.6%	2.4%

In terms of purchasing power, the pensions as adjusted by the ad hoc increases are shown compared to the value that would have been derived by an adjustment equal to the full CPI or CPI minus 1 percent:

	CPI	CPI minus 1
Retired 5 years ago	91%	96%
Retired 10 years ago	98%	108%
Retired 15 years ago	85%	98%
Retired 20 years ago	84%	102%
Retired 25 years ago	58%	74%

Following presentation of the report's contents, Senator Kerr addressed Mr. McElhaney, for which the questions and responses were requested to be placed in the minutes:

Senator Kerr: "On your CPI comparison chart with how we have done on ad hoc COLAs, it would appear that taken over all the range of years, throwing out for the moment those retired 25 years ago, if you look at the range of the other four that we're almost dead-on with CPI minus 1. The only problem that we had in maintaining buying power is for those who retired 25 years ago who would be approximately 85 right now. There aren't too many of them. That would not be a very serious problem cost wise, seriously. It would not seem to be a problem that would be terribly hard financially to fix. Would that be amenable now?"

Mr. McElhaney: "Yes."

Senator Kerr: "This almost looks like the kind of stuff that you should be doing high fives about if you had been that successful in maintaining the buying power. Is that a misinterpretation of this material?"

Mr. McElhaney: "I don't know about the high five part, but yes, it's fair to say at this point in time that the history of ad hoc COLAs has kept the retirees over the last twenty years up with inflation, with a caveat that before the mid-1990s these increases were done fairly frequently and since then they have not been

done frequently so at this point in time you're right, but if there is not any continuing of it, you know, what the results would be ten years from now would depend upon what action is taken over the next ten years."

Senator Kerr: "Inflation more recently has not been quite as great a challenge. Mr. Chairman, I would ask that we make sure that those comments from Mr. McElhaney be in the minutes because I think they are a matter of some contention and they are dealing with a factual issue here and I think his comments as to what the facts are, is worth making sure they are in our minutes."

Senator Barone addressed Mr. McElhaney with further questions regarding his report which he also requested the questions and answers be included in the minutes.

Senator Barone: "As we look at this table and I agree with my colleague, Senator Kerr, that this table does tell a story. Do you have available the specific information year by year? For example, if we went back 25 years ago or 24 to see how those individual retirees would have faired depending on the year they retired?"

Mr. McElhaney: "You mean a year by year report on COLAs? Ad hoc COLAs?"

Senator Barone: "Yes. If we could have that year by year with the inflation in there year by year because you know when we get back into the last, well just think year by year may tell us a story when you look back at the late 1970s for example when we had the horrendous double digit inflations, because if you go back 25 years ago, I gather you are going back to 1976. If you get 1976 through 1980, I don't understand, are you suggesting that in the period of 1976 through 1980 that the CPI was only 4.6 percent? In that five year period, or are you suggesting in the 25 year cumulative period?"

Mr. McElhaney: "I would say 25 year cumulative period. The effect of going from 20 to 25 years increases the average from 3.4 percent to 4.6 percent just adding those five years."

Senator Barone: "Okay, so that is the cumulative effect?"

Mr. McElhaney: "That's the cumulative affect. The average for the last 20 years if 3.4 percent. When it goes to the last 25 years, it is 4.6 percent. So obviously those are pretty high inflation rates during those five years to turn out that average."

Senator Barone: "Okay, so then let's just think about this a little further, if we could, Mr. Chairman. The person who retired 25 years ago, if I am going to use the simple rule of 72, you know how things double, then CPI minus 1 in 25 years would more than double. That's 25 times 3.6 or about 90. So it would more than double in that 25 year period. In fact, it would more than

double by about 30 percent, but now the COLA in that same 25 year group, you take 25 times 2.4 and you get 58 so even though the CPI more than doubled, the COLA for those people was less than that. Is that fair?"

Mr. McElhaney: "Yes, sir."

Senator Barone: "Mr. Chairman, I would like that response and this dialogue in the minutes also because I think as we look at these things to get forward and have to draw up an example, I think we need to look at specific groups of folks and that is also why I would also like to have that year by year table and that may help us, because the folks who retired in the calendar year of 1976, it occurs to me if you agree with the logic trail that I just went down, they are lacking. Would you agree with that? Those folks who retired in 1976, 1977, let's say more than 20 years ago.

Mr. McElhaney: "Yes, in fact, if you look at page, go back to page 24, the people who retired 20 years ago based on CPI minus 1 are effectively whole based on inflation adjustments. We are looking at l0l percent their benefits versus the benefits fully adjusted for inflation, but the person who retired 25 years ago on the CPI minus 1 is only is only 74 percent so, right, there is a 27 percent difference between a person who retired 20 years ago and a person who retired 25 years ago."

Senator Barone: "Okay. Now help me understand further the low we had with CPI. If they retire 25 years ago, what does that 58 percent mean on page 23 or 24?"

Mr. McElhaney: "Yes, if we measure a lack of purchasing power by CPI , the full CPI and then the individual had only 58 percent of where they would have been with fully inflation adjusted benefits. If we use CPI minus 1 as our measurer for our lost purchasing power, then they are 74 percent of where they should be. In any event, they are quite a bit short of the person who retired five years after them."

Senator Barone: "Also, could we reconcile that 4.6, I guess that's the annual rate of CPI rules for each of the last 25 years?"

Mr. McElhaney: "Yes."

Senator Barone: "How does that relate to the 58 percent. If I take 25 years times 4.6, I get much more than 58 percent."

Mr. McElhaney: "Well that is all set by the 2.4 percent average ad hoc COLAs."

Senator Barone: "I am just looking at the CPI column. I'm sorry."

Mr. McElhaney: "Right."

Senator Barone: "What does that column mean? Maybe I should ask that question."

Mr. McElhaney: "You mean the table at the bottom?"

Senator Barone: "Uh huh."

Mr. McElhaney: "The second table."

Senator Barone: "Uh huh."

Mr. McElhaney: "It's the ratio of the benefit that would be fully adjusted by CPI compared to the benefit that is adjusted by the actual ad hoc COLAs under KPERS."

Senator Barone: "So that makes my point dramatic then. Those folks who retired 25 years ago are short of maintaining purchasing power?"

Mr. McElhaney: "That is correct."

Senator Barone: "Okay."

The Committee then addressed other questions about the report. Senator Kerr indicated that he disliked the tables on page 24. Mr. McElhaney stated he had no particular tie to the table on page 24 and would remove it if it were desired that he do so. Chairperson Stone requested that the table on page 24 of the Post-Retirement Benefit Adjustment Study be removed.

Afternoon Session

Mr. McElhaney presented a preliminary report on the Actuarial Audit of KPERS which he explained would be submitted as a final report before January 31, 2002 (Attachment 3). The Committee took no action on this item and expects the final report to be available in January 2002.

Next to appear before the Committee was Glenn Deck, Executive Director, KPERS, who reviewed the proposed 2002 KPERS legislation (Attachment 4). Mr. Deck also reported on the costs of providing a minimum monthly benefit of $500 for KPERS retirees with 20 or more years of service (Attachment 5).

Pat Beckham, KPERS Actuary, Milliman USA, provided a fiscal note for changing the rule of 85 and also a projection of the contribution rates associated with the concept of equilibrium (Attachment 6).

The issue about long-term effects of actual contribution rates lagging behind the actuarial rates was discussed. As a result, the unfunded actuarial liability is adversely

impacted by under-contributions from employers, most notably the state, for the regular KPERS plan involving the state/school group. For a number of years since 1993, the state and other employers (local units) have been contributing less than the actuarially recommended rates for regular KPERS members. The Legislature had provided for increasing statutory employer contribution rates gradually over a number of years to phase-in payment for a major adjustment in benefits that was granted by the 1993 Legislature, rather than for immediately contributing at the actuarial rates. Based on previous valuations, progress was being made in reaching a point where the actuarial rates and statutory rates were projected to be the same, and that point was referred to as equilibrium. The original June 30, 2000, valuation had caused concern when modeling the results of that study indicated that the equilibrium date had moved from 2005 to 2016.

The December 31, 2000, valuation and the resulting projection of contribution rates suggested that the equilibrium point will not be reached prior to plan year 2033. The KPERS actuary stated that "Under current projections, with a level active population, the actuarial and statutory rates for the state/school group are not projected to converge before 2033, if all actuarial assumptions are met." The actuarial and statutory contribution rates are projected to converge before 2033 for the local group, however.

For the state/school group, the estimated shortfall in employer contributions may be calculated as the difference between the actuarial and statutory contribution rates multiplied by the estimated coverage payroll. The KPERS actuary supplied three different versions of projections (Attachment 6, pages 12 to 14). It was pointed out that projections are less valuable farther out in time.

The actuarial projections are based on a number of assumptions, and the investment rate of return set at 8.0 percent is based on the KPERS Board of Trustee's adopted policy. In recent years when double digit gains were common, projections reflected such windfalls. However, with a declining market reflected in recent months, negative gains impact the modeling.

Mr. Deck, in responding to the estimates, indicated that the actuarial projections show a long-term funding issue and that employer contribution levels will need to be increased long-term to close the gap between the actuarial rate and statutory rate. The KPERS actuary concurred that a new funding plan was needed to address the shortfall, either increasing the statutory cap or some other options.

Several other funding options were presented by Mr. Deck as examples (Attachment 7). One anticipated that a small KPERS group known as TIAA, with an unfunded liability to be paid off by FY 2006, could be "absorbed" as special members and the unfunded liability incorporated into KPERS. Contributions of $9.3 million estimated in FY 2004 could be redirected to KPERS.

Another option involved reducing the employee contribution rate from 4.0 percent to 1.0 percent, and having the state pick-up the 3.0 percent in lieu of giving employees a 3.0 percent pay increase. The net gain would be increased employee take home pay and a cost to the state of an additional 2.64 percent to replace the employee contribution revenue stream to KPERS.

A third option was issuing pension obligation bonds that would be used to refinance the unfunded actuarial liability. The proceeds from taxable bonds would be deposited in the KPERS Fund, and then invested with other assets. The state liability would be to make periodic payments for principal and interest to bond holders. The net effect would be to lower and restructure annual employer contributions for pensions. Projected "savings" would be the difference between the assumed actuarial investment rate of return (8.0 percent) and bond costs.

The Committee endorsed pursuing more research into the bond option and asked KPERS to report at a later meeting on the subject of pension obligation bonds.

Also distributed to each member of the Committee was a KPERS investment history summary (Attachment 8) and a summary of the investment litigation (Attachment 9).

Addressing the Committee regarding Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 was Rod Woodward, Chief Investment Officer, KPERS. Mr. Woodword described EGTRRA as the most significant piece of federal retirement legislation since l986 (Attachment 10).

Mr. Woodward also provided members of the Committee with reports on the KPERS investment performance for the period ending October 31, 2001 (Attachment 11). An unaudited estimate of the interim investment report though November 30, 2001 also was presented (Attachment 12).

Julian Efird, Kansas Legislative Research Department, distributed a draft copy of the Committee report and highlighted areas which needed further consideration by the Committee (Attachment 13). Mr. Efird called to the Committee's attention to five bill drafts and the Committee's previous recommendations. Staff of the Revisor's Office supplied a copy of each bill draft for members to review. Copies of the documents would be available from the Revisor's Office.

1RS 1353: An act concerning retirement and pensions; relating to the retirement system for judges; mandatory retirement age.

1RS 1415: An act concerning retirement; relating to local police and fire pension plans; contribution rates.

1RS 1412: An act concerning retirement; relating to the Kansas public employees retirement system thereunder; benefits eligibility; purchase of participating service.

1RS 1358: An act concerning retirement; relating to schools; early retirement incentive programs.

1RS 1383: An act relating to tax sheltered annuities provided for employees of community college and school districts.

Regarding SB 46 pertaining to mandatory retirement age of 75 for judges, Senator Barone asked Kathy Porter, Assistant Judicial Administrator, if it had been evaluated whether this bill would have a positive or negative effect on the judges as far as budget is concerned. Ms. Porter replied that at the present time they have more retired judges who want the senior judge contracts than they are able to supply contracts for. At this time they do not feel that this would have a big impact on them.

Chairperson Stone recommended that HB 2536 be heard in House Appropriations Committee since the Committee did not adopt a recommendation regarding disposition of this bill.

Regarding 1RS 1412, an act concerning retirement, *Senator Barone moved to introduce the bill into the House. Motion was seconded by Representative Cox. Motion carried.*

Chairperson Stone announced that on January 14, 2001, the gavel would be passed to Senator Kerr.

The meeting was adjourned.

Prepared by Carol Doel
Edited by Julian Efird

Approved by Committee on:

December 19, 2001