# MINUTES

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM STUDY COMMISSION

August 31, 2011
Room 346-S—Statehouse

**Members Present**

Senator Jeff King, Co-chairperson
Representative Mitch Holmes, Co-chairperson
Senator Laura Kelly
Representative Steven Johnson
Representative Ed Trimmer
William Buchanan
Edward Condon
Christopher Long (via telephone)
Rebecca Proctor
Michael Ryan
Paul Seyferth
Richard Stumpf
Brian Winter (via telephone)

***Ex Officio* Members Present**

Glenn Deck, Director, Kansas Public Employees Retirement System
Mary Torrence, Revisor of Statutes
Alan Conroy, Director, Kansas Legislative Research Department
Steve Anderson, Director of the Budget, Department of Administration

**Staff Present**

Julian Efird, Kansas Legislative Research Department
Michael Steiner, Kansas Legislative Research Department
J.G. Scott, Kansas Legislative Research Department
Gordon Self, Office of the Revisor of Statutes
David Wiese, Office of the Revisor of Statutes
Daniel Yoza, Office of the Revisor of Statutes
Connie Burns, Commission Assistant

**Conferees**

Ron Snell, National Conference of State Legislatures
David Draine, Pew Center on the States
Senator Daniel Liljenquist, Utah State Senate
Phyllis Chambers, Nebraska Public Employees Retirement Systems
Meredith Williams, Colorado Public Employees Retirement Association (via telephone)
Joe Nichols, McCloud and Nichols, Inc., Liberty, Missouri

## Morning Session

The meeting was opened by Co-chairperson Holmes.

### Open Meetings Act Clarification

Mary Torrence, Revisor of Statutes, provided additional information on the Open Meetings Act (Attachment 1).

The definition of "Meeting": A meeting is subject to the KOMA if it meets the following three criteria:

- It is conducted in person or through the use of interactive communication media such as telephone, email or instant messaging, in short, a meeting is interactive discussion among members of the body, regardless of the means of carrying on the discussion and regardless of whether action is taken or a decision is made.

- It includes a majority of the members of the body. Compliance with open meeting requirements is not necessary if discussion is among fewer than half the members of the body.

- It is for the purpose of discussing the business of the body. If members of a body get together socially or at a meeting of another group, they do not have to comply with the open meetings act unless they discuss the business of the body.

While any member of the public is entitled to attend an open meeting, the KOMA does not require that any member of the public be allowed to speak at the meeting or insist that an item be discussed at the meeting.

### Out-of-State Conferees

Ron Snell, Senior Fellow, National Conference of State Legislatures, briefed the Commission on state retirement legislation in 2010 and 2011 (Attachment 2).

In 2011, 27 states enacted significant changes in public pension plans through the end of August 2011. In 2010, 21 states enacted changes, and some states enacted changes in both years. In total, there were 40 states where changes were adopted, and proposed legislation is still pending in several of the remaining ten states. This reflects a major national movement in pension reform and reactions to the following major issues, including concerns about the viability of retirement plans, both the ability to provide benefits and to ensure adequate; severe investment losses in the 2007-2009 recession; and demographic changes and state fiscal conditions.

Almost all states in 2010 and 2011 increased employee contributions. Additional changes in 2010 and 2011 included:

- Longer vesting period for new members – 13 states;

- Longer period for calculating final average compensation (meaning a lower base for a pension in most cases) – 14 states;

- Reduced benefit for early retirement – 16 states – for current employees in five states; and

- Greater restrictions on retirees' return to covered service – 12 states.

Trends in pensions policy in 2010 and 2011:

- With two exceptions, states have revised rather than replaced traditional defined benefit pension plans;

- In 2010, Utah closed its defined benefit (DB) plan for all state and local employees, and began offering new employees a choice of a defined contribution (DC) plan or else a hybrid plan that includes a DB component and a mandatory DC component;

- Also in 2010, Michigan replaced its school employees DB plan with a hybrid plan combining DB with DC;

- Indiana created an alternative DC plan in 2011;

- Costs have been shifted to members through higher contributions, longer service requirements, higher ages for normal retirement, and lower post-retirement benefit adjustments; and

- More restrictions were adopted on retirement before normal age and on retired members returning to covered service (often called "double-dipping).

Contribution requirements in 2011:

- Most states that increased employee contribution requirements in 2011 offset them with lower employer contributions, at least temporarily;

- There is a trend toward equalizing the employer and employee contribution rates; and

- The pension changes also helped balance highly-stressed state budgets (and local government budgets) in many cases.

A short question and answer session followed with Mr. Snell and the Commission.

David Draine, Senior Researcher, Pew Center for the States, provided research on pensions and retiree health care (Attachment 3). The two issue-areas in the pension discussions are the current debate over discount rates and the implications of new accounting rules on pension disclosure proposed by the Governmental Accounting Standards Board.

State revenues remain 9.0 percent below 2007 levels, even as the demands for social services have risen in light of the weak economic situation. Some 45 states faced budget shortfalls for fiscal year 2012 and over the past four years, most states were forced to close over $480 billion in cumulative budget gaps.

The Pew Center on the States examined the Comprehensive Annual Financial Reports of all fifty states, as well as pension plan reports and actuarial valuations. The Pew Center looked at 231 pension plans and 159 plans offering retiree health care and other non-pension benefits. State-run retirement systems had promised $3.6 trillion dollars in benefits, but had only set aside a little over $2.3 trillion to pay for it. Approximately one-half that shortfall is for pensions, where $659 billion in unfunded liabilities exist, while the other half is for retiree health benefits where there is an estimated $604 billion funding gap.

Many states have responsibly managed their pension obligations and have relatively well funded plans, other states have raised benefits, failed to make contributions and in general racked up large unfunded liabilities that they will find difficult to pay for going forward. Thirty-one states were below the 80 percent funded threshold in 2009, an increase from the 22 below that mark in 2008.

The financial crisis of fall 2008 did tremendous damage to pension assets. After a decade of declining pension funding levels, states are starting to take notice as rising pension costs are coinciding with declining revenues and crowding out the needed investments states will need to make to be economically competitive. The bill is already sizable – the actuarial recommended contribution for state-run pension plans was $68 billion in 2009, a 152 percent increase since 2000. In addition, the recommended contribution to pay for retiree health benefits was $49 billion for a combined bill of $117 billion. States and participating localities have only set aside 62 percent of the recommended amount of funding. For the 16 states for which fiscal year 2010 data are now available, the average pension funding level declined slightly from 77 percent to 75 percent from the previous year.

At no point in the last decade have the actuarial recommended contributions been paid to the Kansas Public Employees' Retirement System. Kansas had not set aside any funding to pay for retiree health benefits, although the bill coming due for those promises was estimated at $236 million in 2009, substantially less than the shortfall for pensions.

Pension actuaries need to make a number of assumptions to estimate the bill coming due and how much states need to set aside to pay for it. A key assumption is the rate of return assumed – how much will that money grow through investments before the bill finally comes due. The rate of return assumption has two parts: how much can states expect investments to bring in and how much risk should a state take on its investments. The most common rate of return assumption is 8.0 percent, which Kansas uses as well. Some argue that future returns are likely to be lower and in fact some states are lowering their expectations. Others argue that states are taking on too much risk when they base their rate of return assumptions on the expected rate of return and propose a more conservative rate such as a high quality corporate bond rate such as is used in the private sector or a risk-free rate based on a U.S. Treasury Bond. The advantage of using such an approach is that it makes it less likely that states will face a shortfall.

The Government Accounting Standards Board (GASB) released an exposure draft listing new rules for pension accounting and disclosure reporting. The largest single change is that the unfunded liability for each public employer will now be listed as a liability on the balance sheet for that employer. The funded liability will be a liability of the pension plan but the unfunded

portion will now need to go on the books. This will have major impact on state balance sheets, but should not endanger the ability of states to borrow.

There also will be substantial change as to how the discount rate is derived. States would apply the rate of return assumption only to the portion of the liability that is backed by assets that can be expected to generate future returns. Kansas' liabilities likely will increase due to this policy shift.

Under the new rules, there will be greater standardization as to how pension plans can estimate their liabilities. Right now there are six allowable cost methods that states can use to estimate how much they owe for retirement benefits and how much they should contribute each year. If these new rules go into effect, all pension plans would have to use a single approach—the Entry Age Normal method. Kansas already used Entry Age Normal so this should not change the state's reported liabilities.

Co-chairperson Holmes introduced Senator Daniel Liljenquist, Utah State Senate (Attachment 4). Senator Liljenquist provided background information on Utah's Retirement System. Utah has never borrowed money from its pension trust fund, has always paid the full actuarial recommended contribution rates, has not increased retirement benefits in over 20 years, and maintained a funded ratio that averaged 95 percent between 1997 and 2007.

Utah's pension fund lost 22.3 percent of its value in 2008. The Utah Legislature requested a complete estimate from its actuaries with market returns of 6.0, 7.0, 7.75, and 8.5 percent combined with forty year actuarial projections. Modeled scenarios included:

- Standard option (increase contribution rates);
- Do-nothing option (freeze contribution rates at existing levels); and
- Delay options (freeze contribution rates for three or five years and then increase contribution rates).

Utah's pension system still appeared to be in excellent shape; however, the 2008 losses blew a 30 percent hole in Utah's pension system. Required employer contribution increases in 2008 were manageable, but the projected employer contribution rates would have increased by 75 percent. If Utah had done nothing, it would be bankrupt. So the brutal reality of the 2008 crash meant Utah would have to commit 10 percent of its General Fund for 25 years to pay for the market crash of 2008.

Pension reform objectives were to meet 100 percent of Utah's pension obligations to its current and retired employees, and to eliminate Utah's pension related bankruptcy risk. To meet current pension obligations Utah needed to:

- Pay full actuarial recommended contribution rates; and
- Shore-up the current retirement system by closing incentives for post-retirement reemployment.

Eliminating pension-related bankruptcy risk, Utah needed to pay off the unfunded liability as quickly as possible. A new system was established for new employees with:

- Lower costs; and

- Predictable employer contributions.

Pension reform process must include:

- Ask the hard questions/demand data;

- Be hypothesis driven/avoid ideology;

- Involve all parties/build partnerships;

- Circulate reform proposals broadly;

- Be kind, polite and responsive; and

- Keep moving forward.

Utah's new retirement system allows new employees to choose between: 1) a 401(k)-type plan, or 2) a hybrid pension/401(k) plan. As a result of these changes, the expected results of Utah's pension reforms include:

- Combined retirement contribution rates for public employees will peak in seven years and gradually decline;

- Combined retirement systems and statutory restrictions will help prevent "pension creep";

- Each new employee retirement cost will be less than half the cost of old employees (10 percent vs. 23.1 percent, freeing up resources to fund the "tail" of the current programs); and

- Utah will gradually reduce pension related bankruptcy risk until the risk is eliminated.

Lessons learned include:

- Demand comprehensive, long-term financial modeling from pension actuaries;

- Reality is NOT negotiable – let the data do the work;

- Stick to your established objectives and negotiate around the details;

- Future employees are not an effective lobbying force; and

- Know the details and you will own the issue.

## Afternoon Session

**Out-of-State Conferees (Continued)**

Co-chairperson Holmes called the afternoon session to order and introduced Phyllis Chambers, Director, Nebraska Public Employees Retirement System (Attachment 5). Ms. Chambers provided a history on the Nebraska Public Employees Retirement System which is a Cash Balance Plan.

- Introduced mid-1980’s in corporate sector;
- Defined Benefits (DB) Hybrid – IRS considers it a Defined Benefit plan because of the guaranteed credited rate;
- Individual account consists of employee and employer contributions, which receive interest credits and dividends;
- Member account value never goes down;
- Pooled assets managed by professionals;
- Plan requires an annual actuarial valuation; and
- Annuity is based on account value and employees age, not a formula benefit.

*Nebraska Benefit Adequacy Study*

- 2000 actuarial study;
- Compared State and County with School Defined Benefit plan;
- State and county average annual salaries lower – School $40,000, State $35,000, County $30,000;
- Average annual investment return, five year period – 7 percent for DC plans and 11 percent School DB plan; and
- Retirement income replacement was 5.0 to 8.0 percent higher for DC plans to maintain same standard of living – 78 percent for Schools, 83 percent for State, and 86 percent for County.

*Goals of Cash Balance Plan*

- Improve retirement benefits for state and county employees – from Defined Contribution to Cash Balance;

- Retention – reward long-term employment;

- Offer self-funded annuity and COLA options – over 90 percent of retirees were taking lump sum refunds;

- Reduce Defined Contribution investment and timing risk – 90 percent of employees were in only three of the 12 funds – Market crisis can affect timing of retirement – Reduces investment education for members; and

- Reduce costs and fees – Defined Contribution cost of $92 per member and Cash Balance $71 per member.

*Features of the Nebraska Cash Balance Plan*

The plan is mandatory for new hires. Defined Contribution members had a one-time option to transfer in 2003, and one-third of those eligible actually transferred, and another one-third transferred in 2007 when the Nebraska Legislature opened the plan again.

*Cash Balance Dividends*

The Board may grant a dividend if actuarial contribution rate is at least 90 percent of the actual contribution rate per statute. The Board added an additional policy that the funded ratio must be 100 percent. Dividend based on account value at previous calendar year end, this could be a problem when an employee terminates between December 31 and dividend payment, dividend posts to a closed account. The legislature made statutory and policy changes that once an account is paid out it could no longer receive interest on dividends or late contributions.

*Cash Balance Advantages*

- Good compromise between Defined Benefits and Defined Contribution;

- Minimizes state/employer liability;

- Assets are pooled and professionally managed;

- Less complex and lower cost that Defined Contribution plans;

- No investment education and choices;

- Guaranteed minimum credited rate;

- Optional dividend in good times;

- Excellent lifetime annuity benefit;

- Optional 2.5 percent COLA – paid by members;
- Portable – refund, rollover, annuity or combination. Must be taken at one time;
- Optional transfer to Defined Contribution Plan for systematic withdrawals;
- Record keeping and reconciliation are easier; and
- Enrollment period – deadline in statute – processing time and one time selection in statute.

In conclusion, the Cash Balance Plan is working in Nebraska as designed; it has an eight-year history. There are no actuarial required contributions to date; members have received dividends from 2004 thru 2008. Cash Balance members accounts are increasing with a guaranteed at 5 percent annual rate. Employees are happy and Defined Contribution members want to know if the plan will be opened to transfers again.

Meredith Williams, Chief Executive Officer, Colorado Public Employees Retirement Association (PERA), provided testimony via telephone (Attachment 6). He gave a brief background on the Colorado PERA plan which is a Hybrid Defined Benefit plan. It is the 21st largest plan in the U.S. and the 60th largest in the world. Mr. Williams provided a financial recap of Colorado PERA, Assets vs. Liabilities, and a time line for development of PERA's Comprehensive Legislative Proposal.

Colorado established a framework in order to provide:

- Shared responsibility among members, retirees and employers;
- Inter-generational equity;
- Long-term sustainability;
- Preservation of the Defined Benefit Plan;
- Maintenance of the same benefit structure for PERA's different divisions; and
- Recommendations that are designed to have little or no short-term impact on member behavior.

SB 10-001 put PERA back on track, and contained shared sacrifices. All Divisions are expected to be fully funded in 30 years. Ninety percent of changes come from current and future member and retirees. PERA Board and members, retirees, and employer organizations supported SB 10-001, and serves as a model for other states. The most significant change in the legislation was to take the COLA from 3.5 percent to 2.0 percent; for all of the people who are currently retired and who will retire in the future. Also the plan took a one year holiday from giving a COLA to retirees, and those who will retire in the future will have to wait one full year before they receive a COLA. In addition, if the plan has a negative investment year at any point in time for the next three years, COLA is pegged to the lower of 2.0 percent or the actual CPI-W. This is the portion of the plan that is subject of a lawsuit.

The Commission asked if during the course of the Colorado process the issue of moving from a Defined Benefit to Defined Contribution or Cash Balance or any other Hybrid plan come up, and, if so, could Mr. Williams summarize the content of those conversations and why it was decided to stay with the Defined Benefit and modify that plan. Mr. Williams stated that in Colorado the vast majority of people do not have Social Security coverage, so this plan is all that they have; a significant number of state employees including all future new hires have the ability to opt into a Defined Contribution approach and about 10 percent do participate. The transparency and the cost structure of a Defined Benefit plan as done in Colorado is significantly better than any Defined Contribution Plan in existence.

Joe Nichols, Consulting Actuary and President, McCloud and Nichols, Inc., Liberty, Missouri, addressed questions and concerns of the Commission. Currently, two states and Washington D.C., have a Defined Contribution only plan, the employees have no choice but a Defined Contribution plan. Eight states allow the employees to choose between a Defined Contribution and Defined Benefits plans, and most states have the Defined Benefits plan as a default.

Mr. Nichols stated that there is a study that gives an overview and factors, "*Behavioral Economics Perspectives on Public Sector Pension Plans*" by John Beshears, Stanford University, Graduate School of Business, James J. Choi, Yale School of Management, David Laibson, Department of Economics, Harvard University, and Brigitte C. Madrian, Harvard Kennedy School, Harvard University.

He noted that conversion to a Hybrid or a Defined Contribution plan will not eliminate the unfunded actuarial liability in Kansas. Discussion on transition costs, risk analysis, and the assumption used in the investments followed with the Commission.

## Commission Discussion and Planning for Future Meetings

Co-chairperson King stated that he would like to have those future meetings around the state; this request was approved by the Legislative Coordinating Council for reimbursement of travel costs.

Terri Clark, Assistant Director for Infrastructure, Legislative Computer Services, updated the Webcasting abilities from the Statehouse; which would be at no cost, using existing equipment. Ms. Clark addressed questions and concerns from the Commission members. The video would be archived on the Legislative website. The second part would be citizen integration, question and answer section of the meeting. This would entail the submission of questions by email.

*Senator King moved to have the meetings across the state for the September, October, and November meetings*. *With no second, the motion failed.*

Information on the volunteer retirement incentive will affect funding levels and the unfunded liability and what impact that will have on KPERS. That information is being presented in another interim committee and will be available to the Commission after the Joint Committee on Pensions, Investments and Benefits reviews that program.

*Senator Kelly moved to continue to have the meetings in the Statehouse and have the remainder of the meetings Webcasted. Richard Stumpf seconded the motion.* Discussion on the motion followed. *The motion carried*. Senator King requested to be recorded as a "no" vote.

Topics for future meetings were discussed and included the dynamic model which will be available from the Actuary firm, and would allow the Commission to look at various policy options within the context of real KPERS numbers to get ideas on how different policy options would affect KPERS finances. Also the Commission will start to put together a framework to look at the end game from the different states that have made presentations to the Commission.

*Representative Johnson moved to approve the minutes for July 22, 2011, as distributed. Senator Kelly seconded the motion. The motion carried*.

The next Commission meeting will be September 22-23, 2011, in Topeka. The meeting was adjourned.

Prepared by Connie Burns
Edited by Julian Efird

Approved by Commission on:

October 25, 2011
(Date)