MEMORANDUM

To: House Insurance and Pensions Committee

From: Alan D. Conroy, Executive Director

Date: February 24, 2021

Subject: House Bill 2399; Reamortizing the 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 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 2399 extends the amortization period for the KPERS State/School legacy unfunded actuarial liability by 10 years. The legacy unfunded actuarial liability is the liability that existing on December 31, 2015 and represents more than 99% of the total unfunded actuarial liability. The recommended reamortization is effective as of December 31, 2018, which sets the employer contributions rates for FY 2022.

HB 2399 also deletes the remaining payments for delayed employer contributions from FY 2017 and FY 2019 and adding the balance to the legacy unfunded actuarial liability. The 2016 Legislature approved delaying $64 million in employer contributions in FY 2017 and $194 million in employer contributions in FY 2019. These delays were to be paid over 20 years on a level-dollar amortization. The payments include:

- $6.4 million per year starting in FY 2018 for the delayed FY 2017 employer contributions.
- $19.4 million per year starting in FY 2020 for the delayed FY 2019 employer contributions.

HB 2399 does not make changes to the amortization schedule for the Local group, KP&F or Judges Retirement System.

HB 2399 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 2004.

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 unfunded actuarial liability that existed on December 31, 2015 continues to be amortized over the remainder of the initial 40-year period (14 years remaining as of December 31, 2018). Experience in future years is amortized over separate amortization layers, each with a separate pay schedule. The sum of each layer is the total unfunded actuarial liability. Currently, the legacy unfunded actuarial liability makes up more than 99% of the total unfunded actuarial liability.

The Board completed a yearlong review of all actuarial assumptions, including amortization policy in January 2020. At that time, the Board voted to maintain the existing amortization schedule. The Board will again review all actuarial assumptions, including amortization, during calendar year 2022.

Cost Impact of Reamortizing the Legacy Unfunded Actuarial Liability

Extending the amortization period to 24-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 over the amortization period.

Employer contributions will be lower under a 24-year reamortization than the current funding plan for 14 years (when the current funding plan is scheduled to end). Over those 14 years, employer contributions are lower starting at approximately $180 million in FY 2022 to $263 million in FY 2035. The average over the 14 years is about $220 million lower annually because of the proposed reamortization.

Higher contributions in later years. Extending the amortization of the legacy State/School unfunded actuarial liability increases total projected cost to reach full funding. Over the final 10 years of the new 24-year amortization, the annual contributions are projected to be about $771 million more on average each year than the same period under the current funding plan. The projected cost over the next 30 years (FY 2022-FY 2051) under the 24-year reamortization totals $18.158 billion, $4.6 billion more than the projected cost under the current funding plan.

Negative amortization. By design, a level-percent-of-pay amortization that is 24-years in length is not making the full interest payment on the unfunded actuarial liability in the earlier years of the amortization schedule. This is called "negative amortization" and results in a growing unfunded actuarial liability. The current funding plan on the legacy unfunded actuarial liability has 14 years remaining (as of 12/31/2018) and an increasing portion of the payments is now paying the principal of the unfunded actuarial liability. Due to deferred investment gains, the negative amortization period under the proposed 24-year amortization schedule is 6 years. The existing amortization schedule is already past the negative amortization period and is paying a larger proportion of the principal on the unfunded liability each year.

Higher unfunded actuarial liability. Under HB 2399, the State/School unfunded actuarial liability increases initially to $6.78 billion and remains above $6.0 billion until 2030 before decreasing towards the end of the 25-year period. The current funding plan is projected to have an unfunded actuarial liability of $3.02 billion in 2030. The unfunded actuarial liability is projected to be extinguished in 2035 under the baseline, compared to $5.19 billion remaining in FY 2035 with reamortization.

Lower funded ratio. Reducing the flow of assets into the Trust Fund and a higher unfunded actuarial liability means that the funded ratio (actuarial assets ÷ actuarial liabilities) for the State/School group remains lower for a longer period.

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.

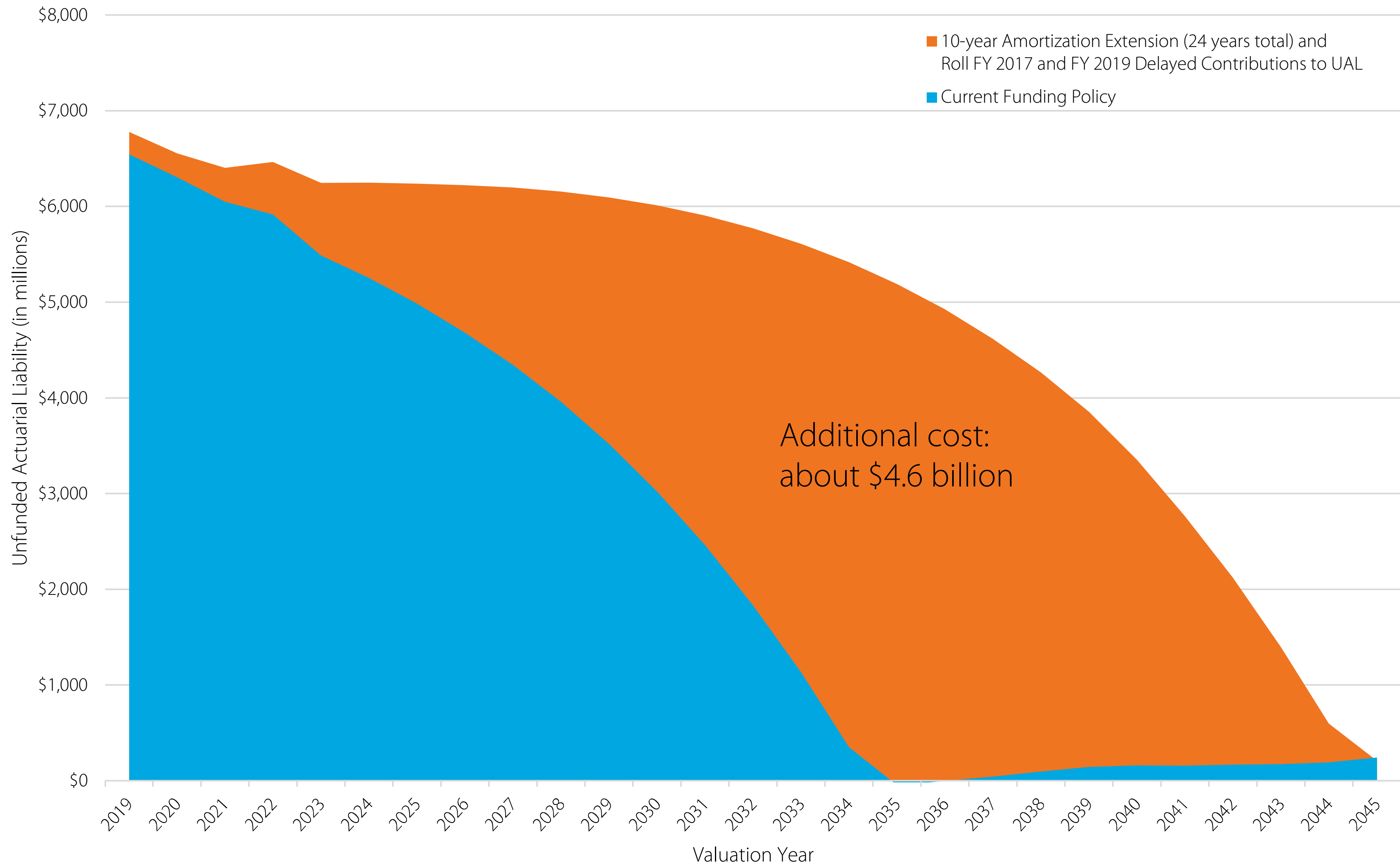
The actuarial cost projections for HB 2399 show that the State/School funded ratio under reamortization would remain below 80% funded until 2034, 8 years longer than the projection under current law.

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. Also attached is an overview document on KPERS funding policy and the impact of reamortization.

I would be pleased to respond to any questions the Committee has regard HB 2399.

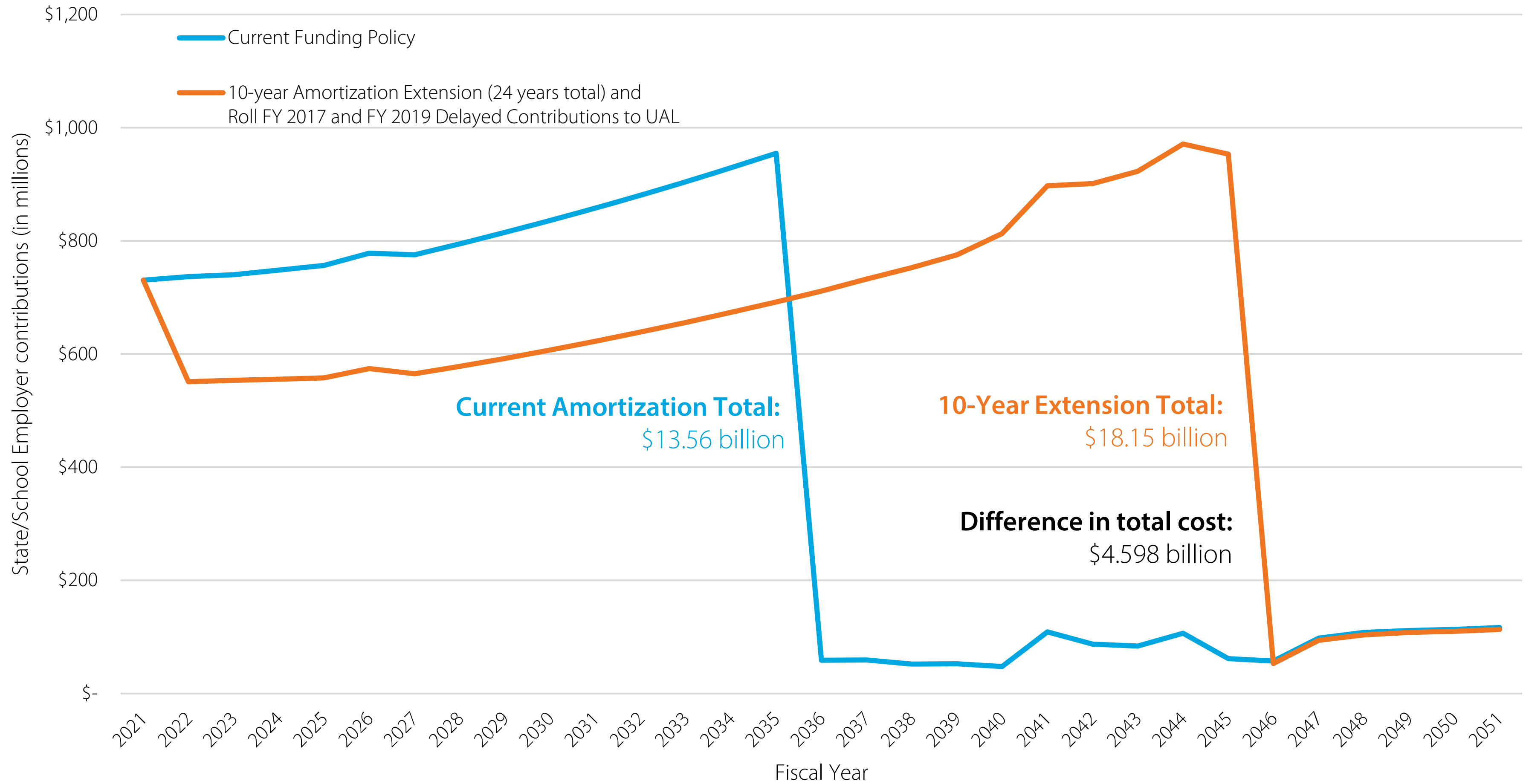
Attachments



NOTE: Projections are based on the December 31, 2019 actuarial valuation and assume that all assumptions used in the valuation are met each year in the future, including the 7.75% assumed rate of return. Note that, in our professional opinion, this set of economic assumptions does not comply with Actuarial Standards of Practice. To the extent actual experience differs from that assumed, the actual valuation results in future years will also differ from the projections shown here. Please see the December 31, 2019 valuation report for details on the actuarial methods and assumptions used in this study.

KPERS

January 2021



Employer contributions include 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).

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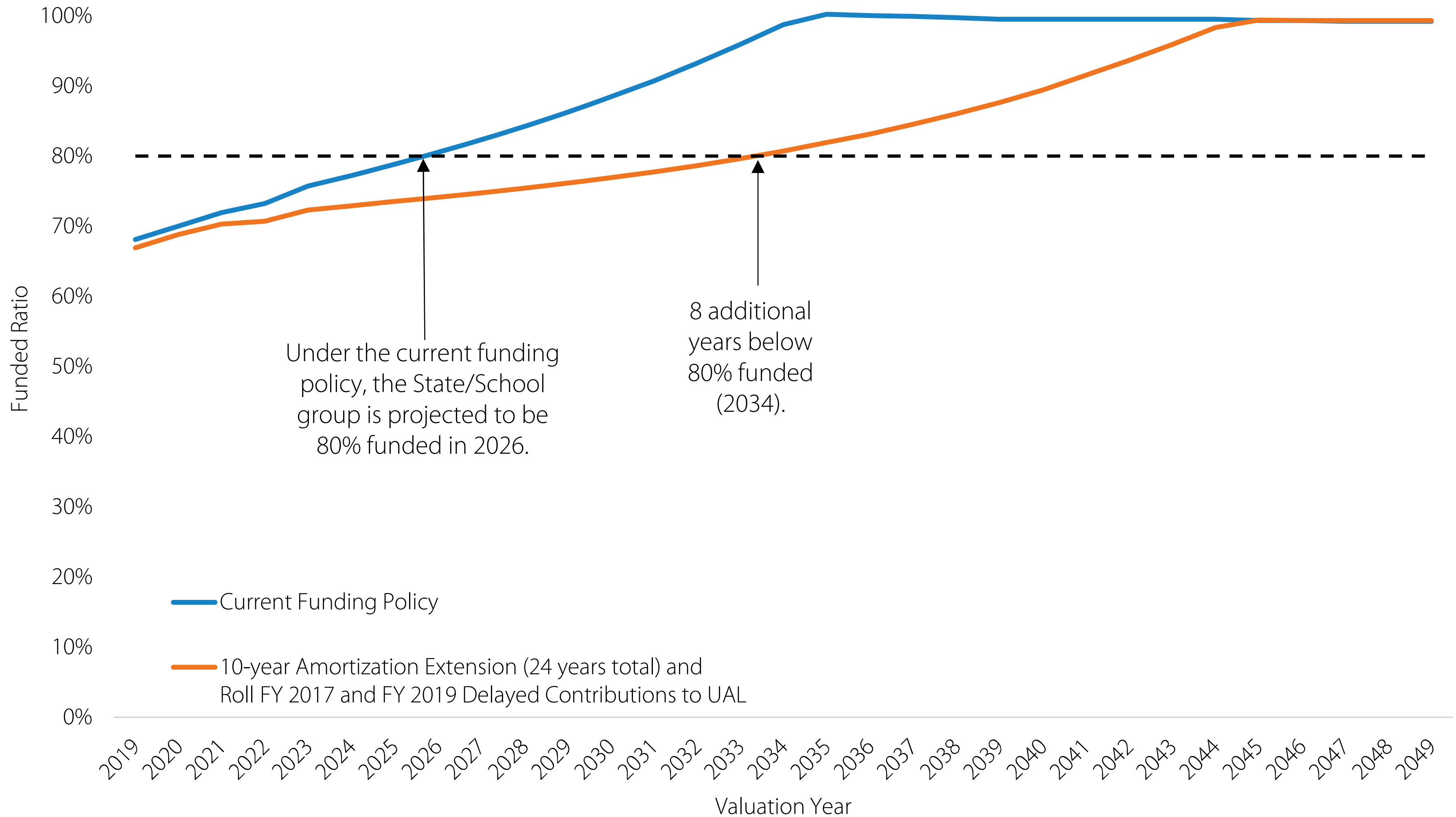

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KPERS **FUNDING** POLICY

How Long-Term Funding Architecture Affects Financial Soundness

KPERS' Funding Shortfall

KPERS has a long-term funding shortfall due to:

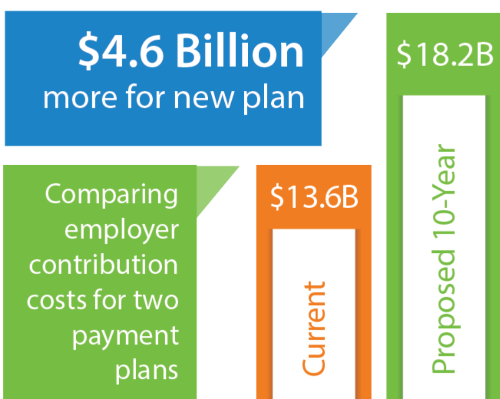
- Decades of lower, delayed and missing employer contributions.
- Signficant market downturns in 2001 and 2008.
- Unfunded benefit enhancements.
- Actuarial assumption changes.

The shortfall has created a legacy unfunded actuarial liability. Having an unfunded liability is not necessarily bad or uncommon, as long as there is a plan to pay for it in a reasonable amount of time. KPERS' unfunded liability is paid for as part of employer contributions over time. The debt is amortized, much like a home mortgage.

The KPERS Board of Trustees reviews all actuarial assumptions (including amortization) as part of its regular triennial experience study. In January 2020, the Board completed a new 12-month study and decided to maintain the current schedule. Retirement systems often reamortize within the last 10-15 years of the amortization period. *But having a sound funding position beforehand is critical.*

Adjusting KPERS' Funding Policy

The State has many competing budget priorities, and funding the State's KPERS obligations is a significant commitment among them. The Governor recommends extending the existing State/School legacy unfunded liability by 10 years, ending in 2043 instead of 2033. This does not include KPERS Local, KP&F or Judges. As with refinancing a home mortgage, reamortization helps lower payments in the short-term, but takes longer and costs more in the long run.



Projected cost for KPERS' current amortization plan compared to the proposed new plan

Benefits Are Secure

Reamortization does not impact retiree benefits.

Current Amortization

- 40-year closed period
- Extinguishing in 2033
- Contributions going directly toward "principal," instead of just interest
- A KPERS' Board responsibility

Why Amortize?

- Funding improvement over time
- More consistent employer contribution rates
- Cost equity between current and future generations

Why *Re*amortize?

Funding payments are designed to increase over time with payroll growth and inflation. Reamortization lowers the risk of contribution volatility caused by market conditions toward the end of the original amortization period.

KPERS' Board studies actuarial assumptions (including amortization) every three years. Sound funding is a necessary condition for "best practice" reamortization.

KPERS

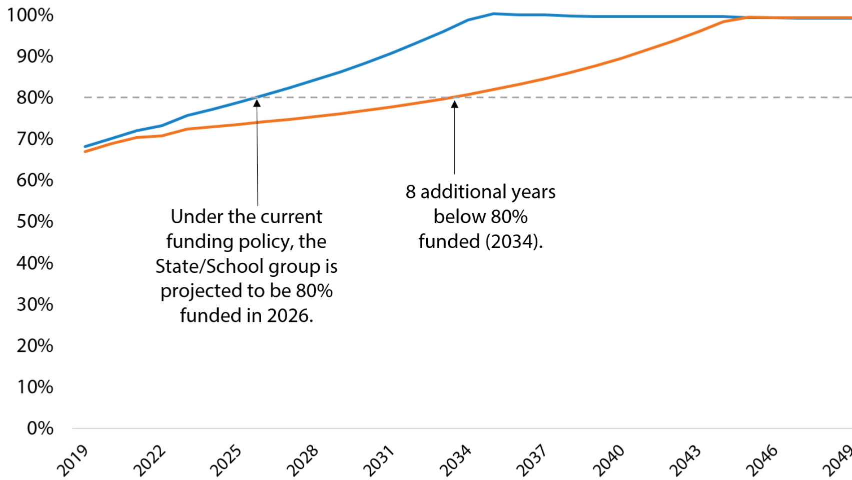
The Effects of Reamortization

In addition to increasing cost over time, a lingering unfunded actuarial liability and lower funded ratio means KPERS will be more vulnerable to adverse market conditions for more than a decade.

Improving KPERS' Funded Ratio

Reamortizing with the proposed 10-year extension:

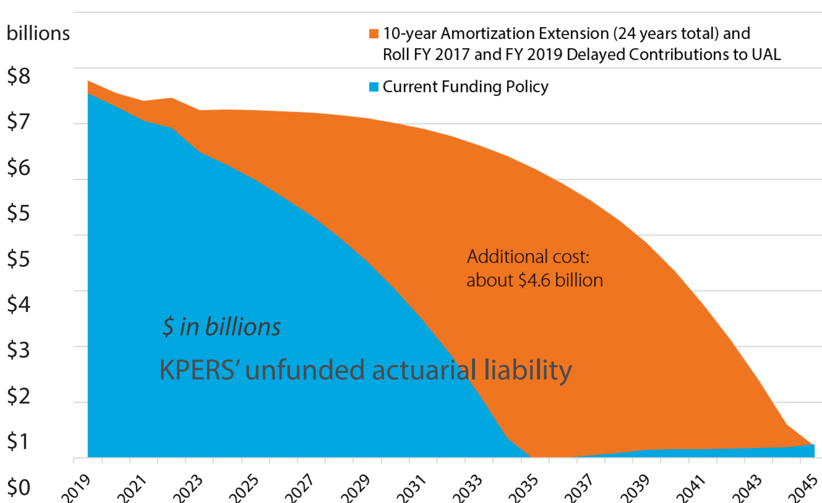
- Takes an additional eight years to reach 80% funded status.



Paying Off KPERS' Legacy Unfunded Actuarial Liability

Reamortizing with the proposed 10-year extension:

- Costs an additional $4.6 billion.
- Keeps the unfunded liability at over $6 billion until 2030, double the liability at the same point in the current plan.

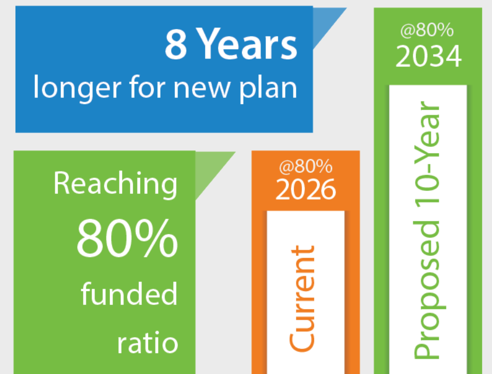


Healthy Funded Ratio

The funded ratio is the ratio of assets to the cost of future benefits.

For public pension plans like KPERS, funding over 80% and rising is good, with the goal of 100%. Funding below 60% is poor and needs prompt attention.

KPERS' *State/School group* currently has a 68% funded ratio. Reamortization with a 10-year extension would keep KPERS below 80% and more vulnerable to market downturns for an extra eight years.



Pay Me Now or Pay Me Even More Later

Reamortization would allow the State to put off paying about **$968 million** over the next five years in employer contributions, including $185 million in FY 2022. This short-term gain is projected to cost the State **$4.6 billion** over time.