

## MEMORANDUM

To: Senate Ways and Means Committee

From: Alan D. Conroy, Executive Director

Date: February 10, 2020

Subject: Senate Bill 321

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).

Senate Bill 321 establishes a 25-year amortization period for the KPERS State/School legacy unfunded actuarial liability. SB 321 does not make changes to the amortization schedule for the Local group, KP&F or Judges Retirement System. SB 321 does not affect retiree benefits or employee contributions.

SB 321 also appropriates \$268 million to pay the remaining principal and interest on delayed State/School employer contributions from FY 2017 and FY 2019.

### **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 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.

This is a relatively new trend for public pension plans, but it has become a “best practice” for the industry. One of the primary benefits of the layered amortization is that there is no contribution “cliff” like there is at the end of a single, closed- period amortization.

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.

### **Recommended Change to Amortization Policy**

The FY 2021 Governor's Budget Report included reamortizing the KPERS State/School legacy unfunded actuarial liability (the liability that existed on 12/31/2015).

The recommendation includes:

1. Set a new 25-year, level percent-of-pay amortization period as of 12/31/2017 for the State/School legacy unfunded actuarial liability. This extends the current amortization by 10 years (ending date of 2043 instead of 2033).
2. Paying the remaining principal and interest on the delayed employer contributions from FY 2017 and FY 2019.

### **Impact of Paying the Remaining Balance of Delayed Contributions**

The additional funding of \$268 million for the remainder of the principal and interest on the delayed employer contributions in FY 2017 and FY 2019 will result in additional funding received by Trust Fund in FY 2020. Making the full payment in FY 2020 is estimated to save \$209 million over the next 19 fiscal years. A series of tables is attached to this memorandum detailing the estimated budgetary savings.

However, the additional funding in FY 2020 does not change the actuarial funding of the System. Because the repayment is set by statute and the delayed payments are being paid with interest, the actuarial calculations already include the funding for purposes of funding calculations. The timing of the payments will not have an effect on the funding projections.

### **Cost Impact of Reamortizing the Legacy Unfunded Actuarial Liability**

Extending the amortization period to 25-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.

In the short term, the State/School group actuarial required contribution (ARC) rate for FY 2021 is projected to decrease from 14.23% to 10.85%, a decrease of 3.38%. The estimated reduction in employer contributions due to the decrease in the actuarial required contribution rate totals \$186.5 million in FY 2021. Less funding to the Trust Fund means lower assets to invest and grow over time and a negative impact on cashflow.

Higher contributions in later years. Extending the amortization of the legacy State/School unfunded actuarial liability increases total projected cost to reach full funding. The projected cost over the next 30 years under the 25-year reamortization (FY 2021 – FY 2050) totals \$20.9 billion, \$4.4 billion more than the projected cost under the current funding plan.

Negative amortization. By design, a level-percent-of-pay amortization that is 25-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 for about half of the amortization period. The current funding plan on the legacy unfunded actuarial liability has 14 years remaining and an increasing portion of the payments is now paying the principal of the unfunded actuarial liability.

Higher unfunded actuarial liability. Under SB 321, the State/School unfunded actuarial liability increases initially to \$7.8 billion and remains above \$6.0 billion until 2036 before decreasing towards the end of the 25-year period. The current funding plan is projected to have an unfunded actuarial liability below \$1.0 billion in 2036.

Lower funded ratio. Reducing the flow of assets into the Trust Fund 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 SB 321 show that the State/School funded ratio under reamortization would remain below 80% funded until 2036, 7 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.

I would be pleased to respond to any questions the Committee has regard SB 321.

Attachments

Remaining Payments on Delayed  
FY 2017 and FY 2019 State/School Employer Contributions

	FY 2017 Delayed Contribution Payment <sup>1</sup> (in millions)	FY 2019 Delayed Contribution Payment <sup>2</sup> (in millions)	Total (in millions)
FY 2021	\$6.4	\$19.4	\$25.8
FY 2022	\$6.4	\$19.4	\$25.8
FY 2023	\$6.4	\$19.4	\$25.8
FY 2024	\$6.4	\$19.4	\$25.8
FY 2025	\$6.4	\$19.4	\$25.8
FY 2026	\$6.4	\$19.4	\$25.8
FY 2027	\$6.4	\$19.4	\$25.8
FY 2028	\$6.4	\$19.4	\$25.8
FY 2029	\$6.4	\$19.4	\$25.8
FY 2030	\$6.4	\$19.4	\$25.8
FY 2031	\$6.4	\$19.4	\$25.8
FY 2032	\$6.4	\$19.4	\$25.8
FY 2033	\$6.4	\$19.4	\$25.8
FY 2034	\$6.4	\$19.4	\$25.8
FY 2035	\$6.4	\$19.4	\$25.8
FY 2036	\$6.4	\$19.4	\$25.8
FY 2037	\$6.4	\$19.4	\$25.8
FY 2038		\$19.4	\$19.4
FY 2039		\$19.4	\$19.4
<b>Total</b>	<b>\$108.8</b>	<b>\$368.6</b>	<b>\$477.4</b>

<sup>1</sup> The first three payments of the delayed FY 2017 State/School employer contributions have been made as scheduled. There are 17 payments remaining on the current schedule.

<sup>2</sup> The first payment of the delayed FY 2019 State/School employer contributions was made as scheduled. There are 19 payments remaining on the current schedule.

Balance Remaining on Delayed FY 2017 and FY 2019  
State/School Employer Contributions on 6/30/2020<sup>1</sup>

Balance of delayed FY 2017 State/School Employer Contributions on 6/30/2020 <sup>2</sup>	\$64.073 million
Balance of delayed FY 2019 State/School Employer Contributions on 6/30/2020 <sup>3</sup>	\$204.339 million
<b>Total Balance Remaining</b>	<b>\$268.412 million</b>

<sup>1</sup> This calculation assumes that the payments scheduled for FY 2021 (July 2020) are not paid.

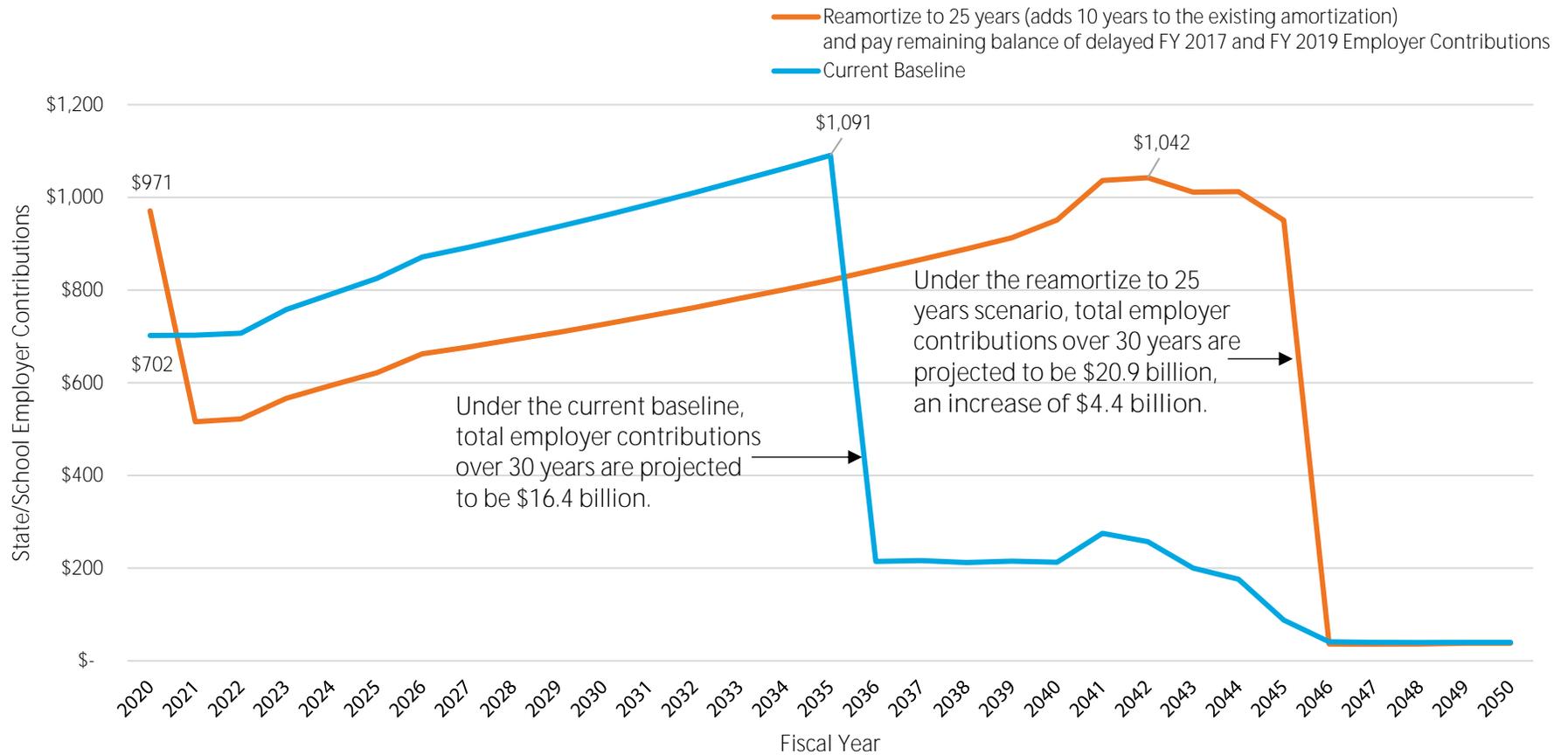
<sup>2</sup> The total amount delayed in FY 2017 was \$64.130 million. There was a one year period before the payments began, which increased the beginning balance due to interest accrued over that year. The remaining balance as of 6/30/2020 reflects the present value of the remaining payments discounted at KPERS investment return assumption (7.75%).

<sup>3</sup> The total amount delayed in FY 2019 was \$194.023 million. There was a one year period before the payments began, which increased the beginning balance due to interest accrued over that year. The remaining balance as of 6/30/2020 reflects the present value of the remaining payments discounted at KPERS investment return assumption (7.75%).

Total Cost Difference Between  
Current Repayment Schedule and Lump Sum Repayment in FY 2020

Total Payments on Delayed FY 2017 and FY 2019 State/School Employer Contributions Over the Next 19 Years	\$477.4 million
Balance Remaining on Delayed FY 2017 and FY 2019 State/School Employer Contributions on 6/30/2020	\$268.4 million
<b>Total Budgetary Savings if Delayed Contributions are Repaid in FY 2020</b>	<b>\$209.0 million</b>

## Projected KPERS State/School Employer Contributions

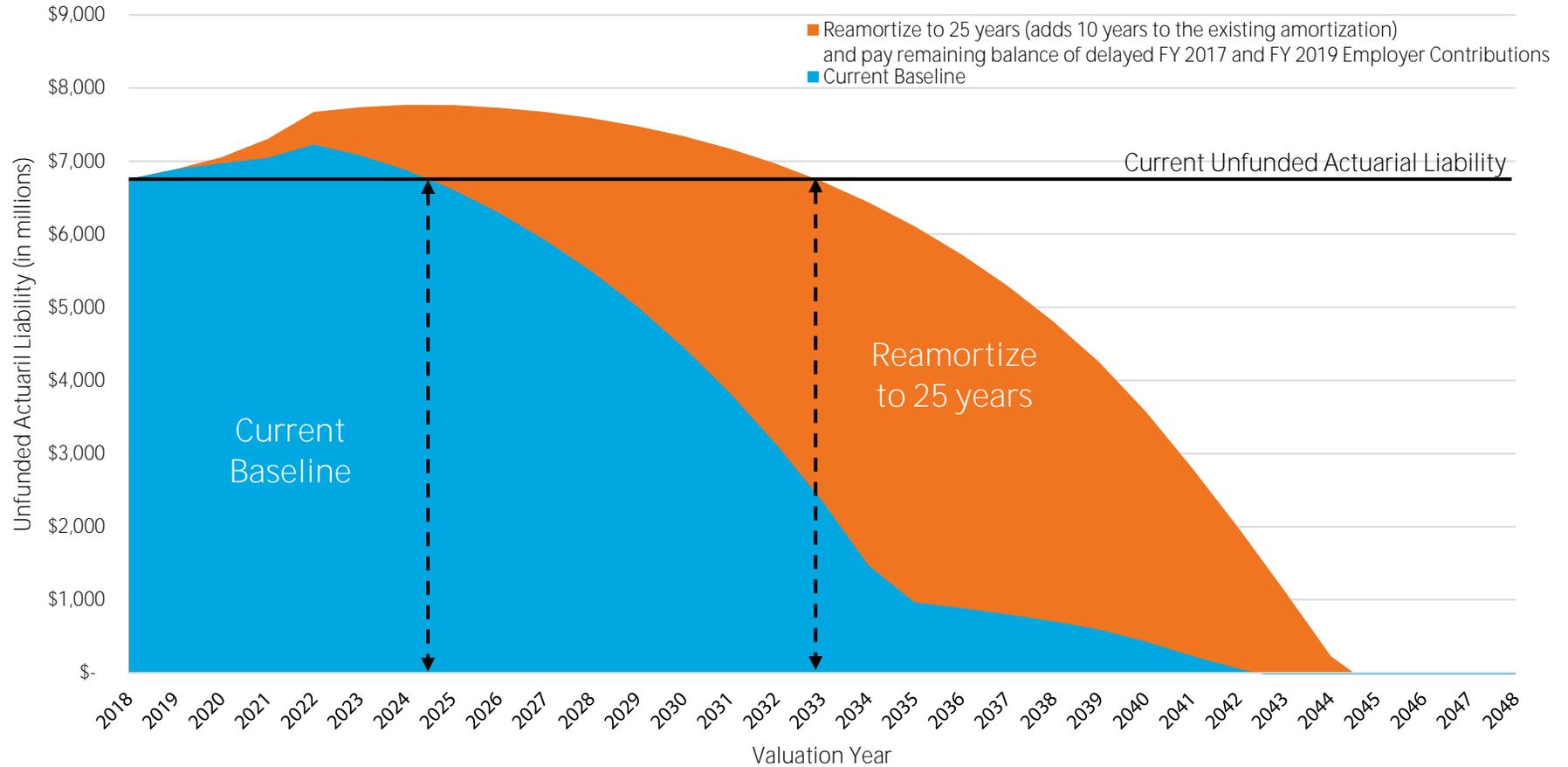


The current baseline scenario reflects the current amortization schedule and the repayment of the reduction to the FY 2017 State/School contributions of \$64 million, as a level dollar amount over 20 years beginning FY 2018, and a reduction of the FY 2019 contribution of \$194 million, with repayment as a level dollar amount over 20 years beginning in FY 2020.

The reamortize to 25 years scenario reflects the \$268 million repayment of the missed FY17/FY19 contributions. In addition, the amortization period for the Legacy Unfunded Actuarial Liability (UAL) base is extended from 15 years to 25 years in the December 31, 2017 valuation. Note that layered amortization is used for all future changes to the UAL and all other existing layers continue to be amortized using the existing amortization periods and method.

Projections are based on the December 31, 2018 actuarial valuation and assume that all assumptions are met in the future, including the 7.75% assumed rate of return. 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, 2018 valuation report for details on the actuarial methods and assumptions used in this study.

## Projected KPERS State/School Unfunded Actuarial Liability

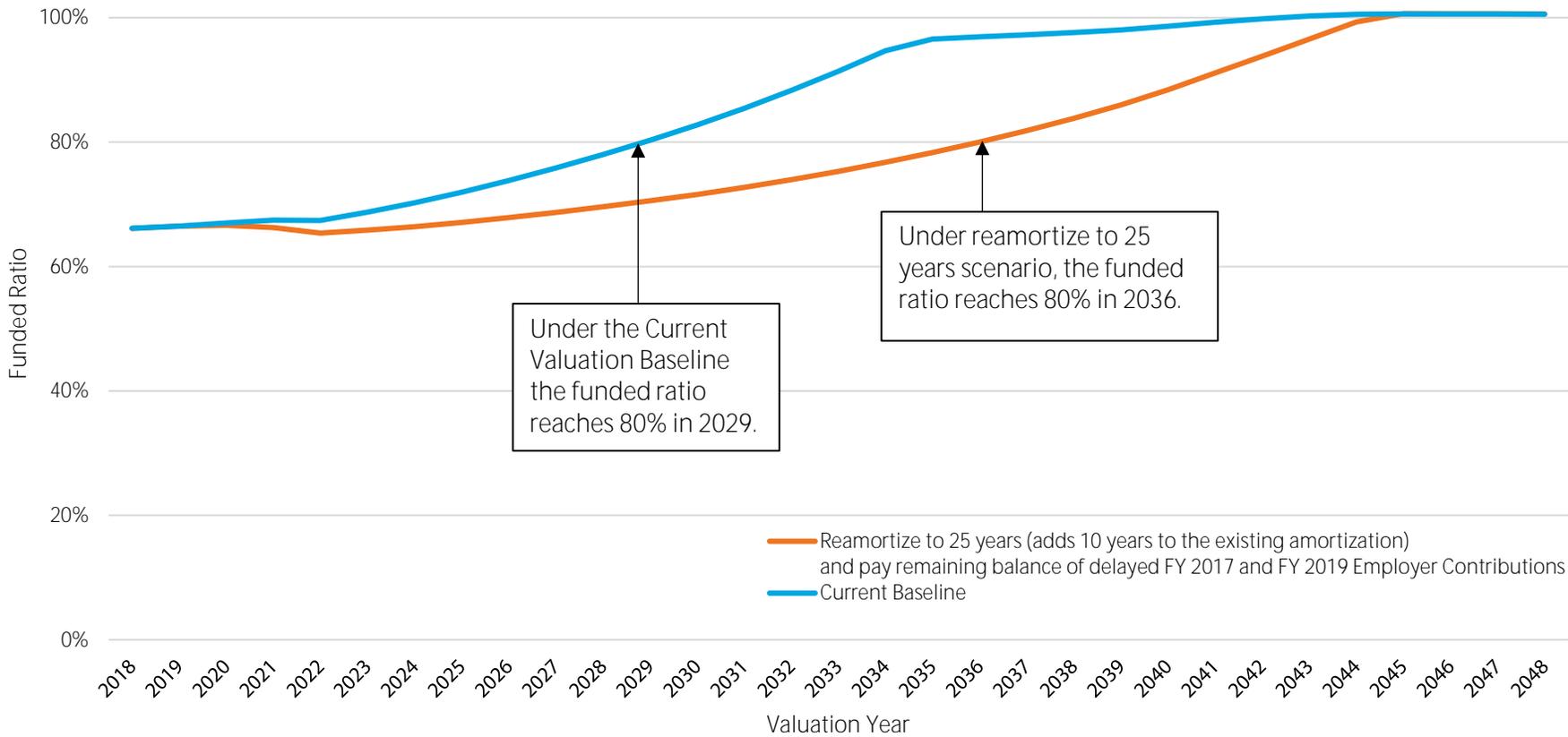


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### Projected KPERS State/School Funded Ratio



The current baseline scenario reflects the current amortization schedule and the repayment of the reduction to the FY 2017 State/School contributions of \$64 million, as a level dollar amount over 20 years beginning FY 2018, and a reduction of the FY 2019 contribution of \$194 million, with repayment as a level dollar amount over 20 years beginning in FY 2020.

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