MEMORANDUM

To: House Committee on Commerce, Labor and Economic Development

From: Alan D. Conroy, Executive Director a.D.C.

Date: May 8, 2015

Subject: House Bill 2426

House Bill 2426 changes the way that sick and annual leave are used in calculating a KPERS member's final average salary at retirement and implements a new cap on the amount of leave that can be accrued by employees of affiliated KPERS employers.

Background

Final average salary is one of the three components of the formula used to calculate a KPERS member's retirement benefit (final average salary X years of service X multiplier). The 1987 Legislature established that final average salary would be the member's highest four years of salary including add-on pay, which is primarily sick and annual leave. The 1993 Legislature changed the definition of final average salary for all members joining KPERS after July 1, 1993 to the highest three years of salary *excluding* add-on pay. That definition of final average salary is still in effect for all KPERS 1 members with membership dates on or after July 1, 1993.

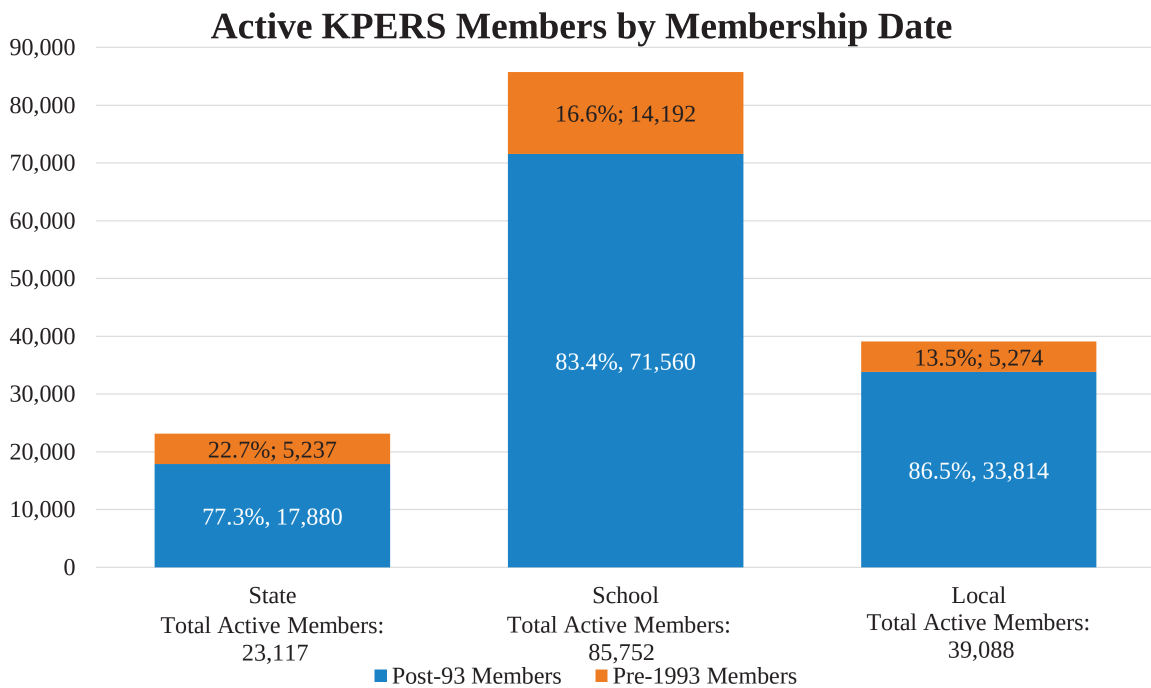
Due to the potential legal issues associated with changing a vested benefit for existing members, the 1993 Legislature left the four year final average salary calculation available to members who had entered the KPERS system on or before July 1, 1993 (pre-1993 members). As a result, their final average salary is calculated two ways – either:

1. The average of the **highest three years** of compensation **excluding** "add-ons" such as vacation and sick leave; or
2. The average of the **highest four years** of compensation, **including** "add-ons."

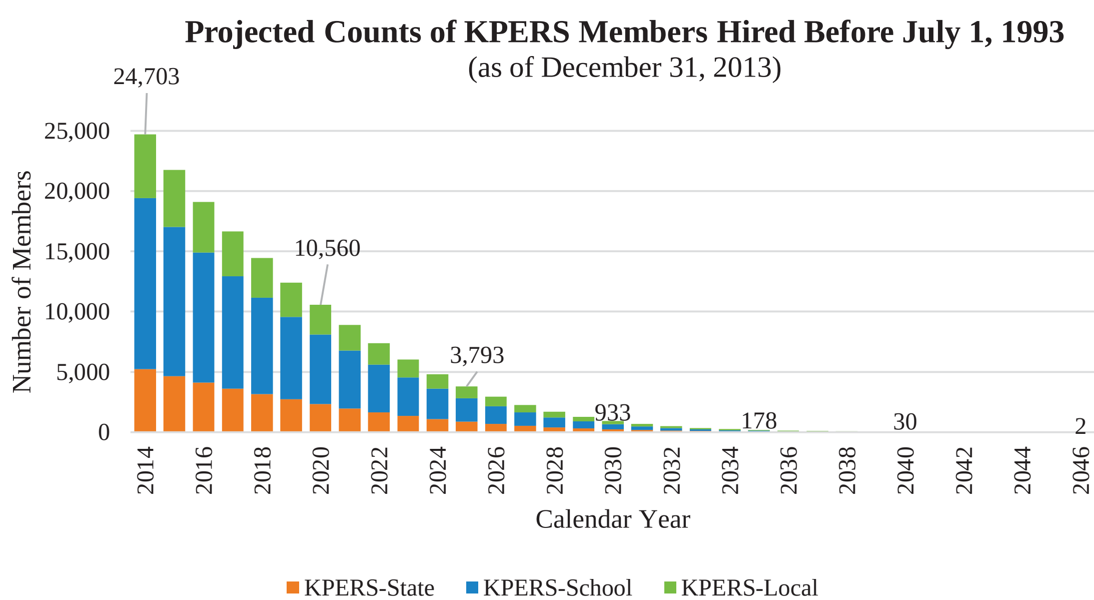
Therefore, add-ons are not used in the final average salary of all pre-1993 members. Based on KPERS' best estimates, the final average salary for the majority (about 80%) of pre-1993 members retiring in 2010 through 2013 was based on a three-year final average salary **without** add-ons.

KPERS

As of the most recent actuarial valuation (December 31, 2013), there were 24,703 active members who entered the KPERS system on or before July 1, 1993, which represents about 16% of the nearly 148,000 active KPERS members.



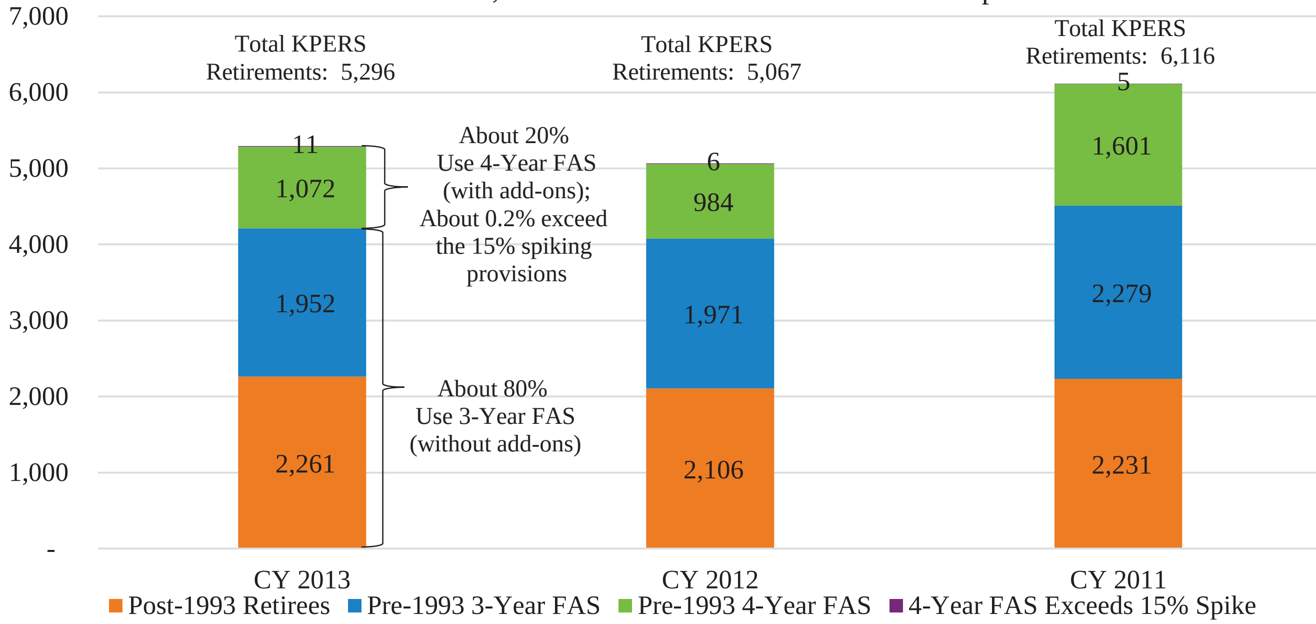
Using the actuarial retirement assumptions for this closed group of members, that number is projected to decrease by more than 50% in the next 5 years and to fall below 4,000 by 2025.



Based on KPERS' best estimates, the final average salary for the majority of pre-1993 members retiring in 2010 through 2013 was based on a three-year final average salary without add-ons. Over the past three calendar years approximately 20% of all KPERS retirees (including 1,083 of 5,296 in CY 2013) have used the four-year final average salary with add-ons, and only about 0.2% of all retirees experienced an increase in their benefit exceeding the 15% spiking threshold.

Count of 3-Year and 4-Year Final Average Salary Calculations*

KPERS-State, KPERS-School and KPERS-Local Groups



**The figures represented are unaudited counts based on a one-off query of KPERS' database and should be considered a best estimate.*

HB 2426

HB 2426 would establish limits on accrual of leave and use of leave in calculating final average pay for those pre-July 1, 1993 members.

- HB 2426 establishes a hard cap of 240 hours on the amount of vacation time that can be accrued by **any** employee of a participating employer, including employees who joined KPERS after 1993. Members above the 240-hour cap on July 1, 2015, would be able to use their accrued vacation leave, but could not accumulate any additional vacation leave so long as the balance remains above 240 hours.
- For purposes of calculating final average salary, pre-1993 members could include in compensation any amount remaining in excess of 240 hours at the time of retirement.
- For a pre-1993 member's final average salary calculation, HB 2426 also caps sick leave at the amount accrued on July 1, 2015. Members could accumulate additional

sick time, but the amount accrued after July 1, 2015, could not be counted as add-on pay for purposes of calculating final average salary.

- Finally, HB 2426 appears to limit the use of add-ons for purposes of calculating final average salary to only those that were earned within the last four years of retirement. The intent of this language is not clear, but it can be read as applying to all forms of add-on pay.

In addition to **limiting the amount of accumulated leave** used in determining the final average salary for pre-1993 members, HB 2426 would **limit the pay rate** that could be used in determining the value of accrued leave. Members would continue to be paid for the accrued vacation and sick leave based on their current pay rate at termination in accordance with the employer's policies. However, for purposes of valuing the vacation and sick leave used in calculating final average pay, the member's pay rate as of July 1, 2015, is to be used.

Actuarial Cost Considerations

By limiting the use and value of vacation and sick leave and other add-ons, HB 2426 would be expected to reduce benefits for some pre-1993 members, and therefore, would tend to reduce KPERS's liabilities. However, KPERS does not have any data regarding members' existing vacation and sick leave balances or the point at which they were earned. Moreover, if HB 2426 is intended to limit inclusion of add-ons earned more than four years before retirement, but paid out at retirement, including compensatory time, no data about compensatory time accruals for KPERS members is available. Therefore, it is not possible to project the actuarial impact of HB 2426.

Some context can be provided by projecting the impact of eliminating use of vacation and sick leave payouts in final average salary calculations for pre-1993 KPERS members. Based on the 12/31/2013 actuarial valuation, KPERS' consulting actuary completed an actuarial cost study evaluating the impact of completely eliminating the use of add-ons in the final average salary calculation. Because HB 2426 would reduce, but not eliminate, add-ons for this closed group, the cost study clearly would overstate the actuarial impact of HB 2426. Moreover, the cost study is based on data that is more than a year old, and due to retirements from this group in the interim, would overstate the impact of such a change.

Totally eliminating use of sick and annual leave was projected to reduce the unfunded actuarial liability (UAL) for KPERS by $49 million. In addition, effectively eliminating one of the final average salary calculations reduces the plan's normal cost, albeit very marginally (0.01%-0.03%). Totally eliminating vacation and sick leave from final average salaries results in a reduction in contribution rates of 0.18% for the State Group, 0.04% for the School Group, and 0.07% for the Local Group. Using the 12/31/2013 payroll estimate and applying the rate reduction above would result in an estimated annual reduction of $1.8 million for the State Group, $1.4 million for the School Group and $1.2 million for the Local Group.

A reduction in actuarial required contribution rates would ultimately result in fewer contributions entering the KPERS Trust Fund. However, because the State/School Group statutory employer contribution rate is below the actuarial required contribution rate, only the Local Group reduction would result in reduced contributions, totaling approximately $1.2 million.

In both cases, the reduced revenue reflects lower employer contributions required to fund benefits for pre-1993 members. However, HB 2426 would not be expected to result in savings of the amount projected by the cost study, and therefore, the contribution rates would not decline to the extent described above.

Administrative Cost Considerations

From an administrative standpoint, KPERS currently has neither processes or systems in place to capture or receive data regarding leave balances and pay rates for the more than 20,000 pre-1993 KPERS members as of July 1, 2015, nor the ability to then apply the data in enforcing the limits in HB 2426 at the future point of retirement for each affected member. If add-ons, including vacation and sick leave, can only be included in final average salary calculations if earned in the final four years before retirement, significant additional administrative resources would be required. Modifications to KPERS' information technology system would be necessary to implement HB 2426, but further analysis would be required to more accurately project administrative costs associated with the modifications.

As noted above, there is some question about the intent of the language in HB 2426. There may be some technical language necessary to clarify the intent so that it is correctly administered.

I would be happy to respond further to any questions the Committee may have.