Fixed Allocation Funding the KERS Nonhaz Unfunded Liability

A Solution to the Percent of Payroll Funding Death Spiral

Introduction

This paper will help legislators and other parties understand the benefits of fixed allocation funding and the critical need for legislation to allow the Kentucky Retirement Systems (KRS) to adopt the fixed allocation funding method for the KERS Nonhazardous Pension Plan.

Background

Pension contributions have two components. The normal cost covers the benefit credits active participants will earn during the upcoming year. The second component is to finance the existing unfunded liability and is referred to as the amortization cost.

How does a pension plan incur unfunded liabilities?

Unfunded liabilities are the liabilities for which there are not assets backing them up. They result primarily from five factors:

1. A shortfall between the ADC (actuarially determined contribution) and the actual contribution. In the case of the KERS Nonhazardous pension plan, the annual funding for 12 straight years (FY 2003 to FY 2014) was less than the ADC. In fact, in seven of those years the payment was less than 50% of the ADC.

2. Changes in actuarial assumptions such as payroll growth and the assumed interest rate. Changes made in the economic assumptions in 2017 resulted in the unfunded liabilities increasing by about $5 billion for all the KRS plans.

3. Investment returns that fall short of the assumed rates. The aggregate investment return for the five pension plans was 6.18% for the 10 years ending 6/30/18. The assumed rates of returns for that period were between 6.75% and 7.50%, depending on the plan.

4. Other experience that is adverse. In March 2019, the Board approved mortality tables that extend the life expectancy in order to better reflect actual experience. This change increased the unfunded liability by nearly $2 billion.

5. Benefit increases that are not pre-funded. Previously approved COLAs contributed to the unfunded liabilities.

The amount of the unfunded liability is equal to the total liability less the assets. On June 30, 2019 KERS Nonhaz had $14.3 B in unfunded liabilities ($16.5 B of liabilities and $2.2 B in assets). The amount of assets as a percent of the total liability is the funded ratio. $2.2 B in assets divided by $16.5 B in liabilities equals a 13.4% funded ratio, the lowest of any State fund.

How should we treat an unfunded liability?

Treat it as if it were a loan, requiring regular periodic payments. The unfunded liabilities are now the largest portion of the contribution requirement for each of the five plans as shown below.

Actuarial Determined Contribution Rate as a Percentage of Payroll

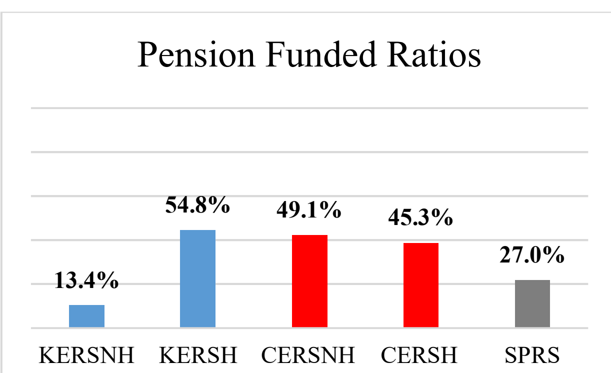
	Average Normal Cost	Average Unfunded Liability Cost	Average Total Cost
KERSNH	**10.4%**	**82.6%**	**93.0%**
KERSH	**13.6%**	**24.1%**	**38.7%**
CERSNH	**9.6%**	**22.4%**	**32.0%**
CERSH	**16.8%**	**40.0%**	**56.8%**
SPRS	**27.6%**	**129.4%**	**157.0%**

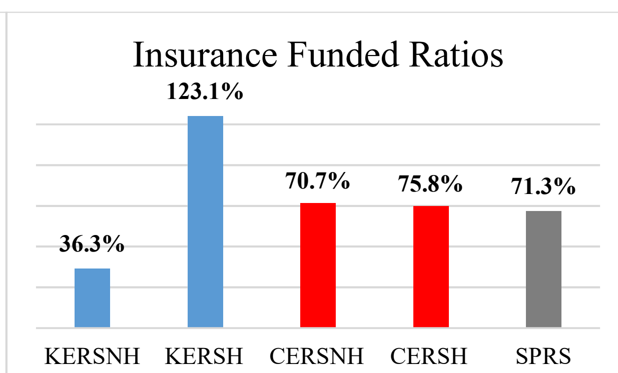
Per the June 30, 2019, actuarial valuation, KRS had the following unfunded liabilities and funded ratios.

Unfunded Liability

$ in Billions	KERSNH	KERSH	CERSNH	CERSH	SPRS
Pension	**$14.3**	**$0.5**	**$7.3**	**$2.8**	**$0.8**
Insurance	**$1.7**	**$(0.1)**	**$1.0**	**$0.4**	**$0.1**

Funded Ratios





What problems does using the percent of payroll funding method create?

To avoid the effect of higher contribution rates, employers outsource, terminate or do not replace departing employees. As a result, their contributions decline because their payroll is smaller. Consequently, other employers have to pick up the cost of those "lost contributions" by having their own contribution rates increase.

Further increases in contribution rates will cause even more employers to cut back their payrolls to avoid having to pay the higher pension cost. Contribution rates could easily exceed well over 100% in the next few years. KRS risks having a pension contribution "death spiral" which will be disastrous.

These dire circumstances may seem extreme but they are within the realm of possibility. Many of the remaining employers (including the State) may not be able to pay these drastically higher contribution rates.

In addition, higher rates could force some Quasi Agencies into bankruptcy. If this were to happen, the entire unfunded liability for those agencies is borne by remaining agencies resulting in even higher contribution rates.

Is there a better way to fund the unfunded liability?

Yes, a funding approach called **fixed allocation funding** is a far more effective way to collect contributions from employers to finance their unfunded pension liability.

How does it work?

The actuary determines the liability for each of the roughly 1,500 employers' current (or former) employees and retirees. This determines the actuarial accrued liability assigned to each of the (roughly) 1500 employers in KRS. The actuary can then determine each employer's liability as a percent of the total liability (their fair share). For example, if a KERS Nonhaz employer's actuarial accrued liability is $165 mil. and the total KERS Nonhaz liability is $16.5 B, the agency will be assigned 1% of the unfunded liability amortization cost each year. As an example, assume the amortization cost for the KERS Nonhaz System is $1.0 B in FY 2021, that employer's unfunded amortization cost will be $10 mil. (1% of $1.0 B).

Since each employer's portion of the amortization cost will be a fixed under this financing method, employers will no longer be able to reduce their pension cost by reducing their covered payroll percentage. It will also be less costly for employers to add new employees under this method since the employers would only be required to contribute the plan's normal cost. Currently that would be 3.05% of pay for both pension and retiree healthcare, rather the having to pay the current full contribution rate which is currently 83% of payroll.

Will the dollar amount of each employer's contribution derived by the fixed allocation method remain the same each year?

No. The fixed allocation percent will remain the same provided no employers exit the System without paying their unfunded liability, as in a bankruptcy. Experience gains and losses may have a minor impact of the total dollar cost but not the percent allocation.

Will there be winners and losers if we change to fixed-allocation funding?

Yes. While there will be no change in the total dollar amount that the System needs to collect, each employer will likely experience an increase or decrease in their annual contribution requirement. Generally, employers with younger workforces and relative fewer retirees will experience a decrease in their annual required contributions. Other employers with older employees and more retirees will have an increase in their annual required contributions. Also, employers who have materially decreased their covered payroll during the last several years likely will experience an increase in their annual contribution requirement.

Overall, the quasi agencies as a group should see about a $34 mil. reduction in their annual contributions that in turn will be borne by the State agencies by means of increased contribution rates, collectively equaling $34 mil.

Will this funding method help solve the KRS pension crisis?

This change will help, but not completely solve the funding problem. KRS still needs the same amount of dollars of funding to finance the unfunded liability. What fixed allocation funding will do is protect the system from having sky rocketing contribution rates for the agencies that remain in the system, who in turn have to cover the unfunded liabilities for agencies that leave KRS and/or reduce their covered payroll.

Can we still compute the cost as a percent of payroll for Federal reimbursement purposes?

Yes. An employer would simply take the dollar cost under the new method and divide it by their payroll.

Do you have any questions?

If so, please contact David Eager, Executive Director of KRS at 502-696-8444 or david.eager@kyret.ky.gov.