

# PERFORMANCE AUDIT REPORT

## Reviewing Benefits Provided by the Kansas Public Employees Retirement System

A Report to the Legislative Post Audit Committee  
By the Legislative Division of Post Audit  
State of Kansas  
December 2000





# ***Legislative Post Audit Committee***

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## ***Legislative Division of Post Audit***

**THE LEGISLATIVE POST** Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$8 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

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December 1, 2000

To: Members, Legislative Post Audit Committee

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This report contains the findings, conclusions, and recommendations from the completed performance audit, *Reviewing Benefits Provided by the Kansas Public Employees Retirement System*. This audit was conducted by Berberich Trahan & Co., an audit firm under contract with the Legislative Division of Post Audit.

The report includes information about the Retirement System's investment responsibilities for non-retirement moneys, and comparisons of benefits with other states. We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton  
Legislative Post Auditor



**EXECUTIVE SUMMARY**  
**LEGISLATIVE DIVISION OF POST AUDIT**  
**Kansas Public Employees Retirement System**

**Question 1: How Does the Kansas Public Employees Retirement System Plan to Implement its Investment Responsibilities for Tobacco Settlement Moneys, Unclaimed Property Receipts, and Other Funds, and Is That Likely To Excessively Dilute the System's Attention to Its investment Responsibility for Retirement Moneys?**

**The legal issues of diverting Retirement System officers and trustees from Retirement System duties need to be considered.** .....page 6  
*In addition to retirement moneys, the Retirement System also is now responsible for investment of other moneys. Applicable legal requirements restrict the use of retirement moneys to paying benefits and reasonable costs of administering the retirement moneys. Those requirements prohibit the use of retirement moneys for other purposes. When the Retirement System was made responsible for investment of non-retirement moneys, it was allowed to charge fees to cover the related costs. However, the System hasn't been given the authority to spend those moneys. As a result, the cost of investing the non-retirement moneys is being paid by retirement moneys.*

**The decision to assign additional duties to the Retirement System raises many practical issues as well.** .....page 7  
*Those issues are finding additional resources to meet the new responsibilities, matching investment strategies with the new responsibilities, arranging for separate investment management in some cases, coordinating information with new agencies, adjusting required reports, and developing systems and procedures.*

**The Retirement System is one of only a few retirement systems that invest non-retirement moneys.** .....page 10  
*Of other state retirement systems contacted:*

- *5 invest only retirement moneys*
- *5 don't even invest retirement moneys (that done by a central investing agency)*
- *only Virginia also invests non-retirement moneys (related costs are charged to the non-retirement moneys)*

**Question 2: How Does Kansas' Retirement and Related Benefits Compare to Those of Selected Other States?**

**The Retirement System's cash benefits generally compared favorably with other states, but cost-of-living adjustments (COLA's) were somewhat less generous than many other states provide.** .....page 13  
*For a hypothetical new retiree, Kansas ranked 3<sup>rd</sup> of 7 in a comparison group of other states' retirement plans. For a hypothetical retiree after 10 years,*

Kansas ranked 5<sup>th</sup> of 6, showing less generous cost-of-living adjustments. Health insurance premium support has an impact on the comparison, as well as the frequency of cost-of-living adjustments. Kansas provides no financial support for health insurance and less frequent cost-of-living adjustments than the comparison group. Kansas generally offered the same types of additional benefits as other states.

**The Retirement System's non-cash benefits generally compared favorably with other states.** Like Kansas, all or almost all 9 states in this comparison group pay for long-term or short-term disability benefits, provide some type of lump sum death benefit for active members, and have some form of death benefits for retired members. ....page 15

**Employee contribution rates in Kansas were about average, but employer rates were among the lowest.** Kansas' employee contribution rate (4%) ranked 5<sup>th</sup> of 9 when grouped with other states contacted. The average for the group was 4.14%. Kansas' employer contribution rate (3.99%) ranked 9<sup>th</sup> of 9 when grouped with the other states. The average for the group was 7.49%. ....page 17

**The Retirement System was not as well funded as many of the other state retirement systems.** Kansas' percentage of current and future benefits funded (86%) ranked 7<sup>th</sup> when grouped with other states contacted. The average for that group was 94.6%. Kansas' ranking can be attributed in part to its relatively low employer contribution rate. ....page 17

**Compared with other states, Kansas requires its employees to be members of the Retirement System a relatively long time before becoming vested.** Kansas was the only state in the comparison group of 11 states that requires a 10-year vesting period. Most (8) of the other states require 5 years or less. ....page 18

**Appendix A: Benefits Offered by Selected  
Midwestern State Retirement Systems** ....page 19

**Appendix B: Agency Response** ....page 22

This audit was conducted by Berberich Trahan & Co., an audit firm under contract with the Legislative Division of Post Audit. If you need any additional information about the audit's findings, please contact Randy Tongier at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.

## **Reviewing Benefits Provided by the Kansas Public Employee Retirement System**

The Kansas Public Employees Retirement System (Retirement System) provides retirement, disability and survivor benefits for Kansas public employees and their beneficiaries. As a result, in addition to the responsibility for investing employer and employee contributions to accumulate moneys for paying retirement benefits, the Retirement System also is responsible for investing tobacco settlement moneys, unclaimed property moneys and the senior services trust fund.

Legislators have expressed concern that these additional investment responsibilities may divide the attention of the Retirement System's investment staff to such an extent that the System's attention to its primary investment responsibility for retirement moneys may suffer.

Legislators have also expressed an interest in having comparative information about how Kansas' retirement and other related benefits compare to those of other Midwestern states.

State law calls for a performance audit topic or topics to be done as part of the annual financial and compliance audit of the Retirement System at least once every three years. This audit satisfies that requirement.

This audit addresses the following questions:

- 1. How does the Kansas Public Employees Retirement System plan to implement its investment responsibilities for tobacco settlement moneys, unclaimed property receipts, and other funds, and is that likely to excessively dilute the System's attention to its investment responsibility for retirement moneys?**
- 2. How does Kansas' retirement and related benefits compare to those of selected other states?**

To answer Question 1, we interviewed Retirement System staff and requested a memo from them summarizing their responsibilities and strategies for investing non-retirement moneys. We sent letters to other retirement systems or investment councils to determine how other states manage non-retirement moneys. To answer Question 2 we sent a survey to ten selected Midwestern state retirement systems to compare retirement and related benefits to Kansas. The Retirement System also completed the survey. Annual audit reports and information obtained from the retirement systems' websites were used to clarify any questions arising from the surveys. In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office.

In regard to Question 1, the assignment of non-retirement moneys to the Retirement System for investment management requires several legal and practical issues to be considered. The System has developed investment policies for those non-retirement funds, but System officials believe they have not received the resources necessary to manage the investments without using the existing retirement fund budget. The System is one of only a few retirement systems that invest non-retirement moneys. Many other states use Investment Councils or the State Treasurer to invest non-retirement moneys.

In regard to Question 2, we found that the Retirement System pays a retirement benefit that is about average compared to the other state systems we surveyed. The employee contribution rate is also about average. Kansas is less generous in granting cost-of-living increases and in subsidizing health insurance than many of the other states. It also has the longest vesting period of the states we surveyed. At the same time, Kansas has the lowest employer contribution rate among those states. The System's actuarial liability is currently 89 % funded, as the unfunded portion has decreased over the past few years. These and other findings are discussed more fully following a brief overview of the Retirement System.

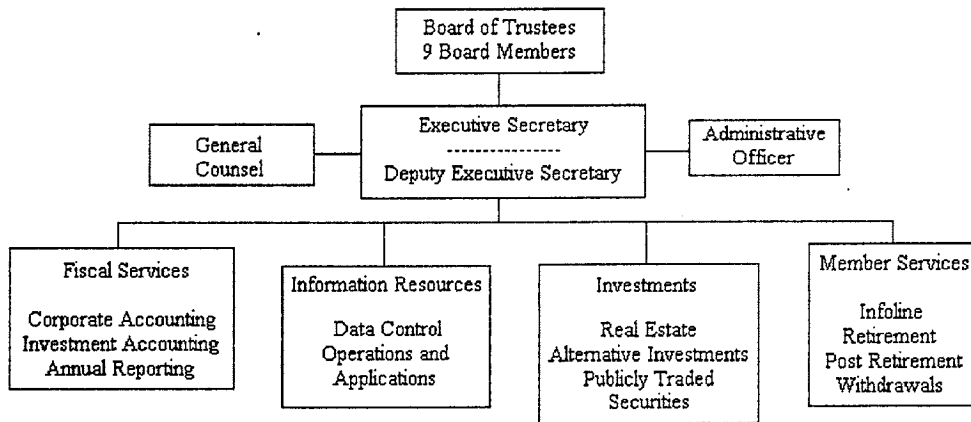
## Overview of the Kansas Public Employees Retirement System

The Kansas Public Employees Retirement System was established in 1961 to provide a systematic retirement plan for public employees in Kansas. In addition to the retirement plan, the System provides group life and disability insurance coverage for its members.

The Retirement System is actually an umbrella organization administering the following three statewide retirement systems under one plan: the Kansas Public Employees Retirement System, the Kansas Police and Fireman's Retirement System and the Kansas Retirement System for Judges. The System covers most state and local government employees in Kansas. On June 30, 2000, the System had 174,734 members (active and inactive), 53,141 retirees and 1,416 participating employers.

On July 1, 1993, a new Board of Trustees was established in accordance with K.S.A. 74-4905. Four members of the nine-member Board of Trustees are appointed by the Governor subject to confirmation by the Senate, two are appointed by the legislative leadership, two are elected by Retirement System members and one is the State Treasurer. The Board appoints an Executive Secretary to manage the daily operations of the System. In fiscal year 2000, the System employed 76 full-time staff members. An organizational chart of the Retirement System's structure is presented below.

### KPERS Organizational Chart

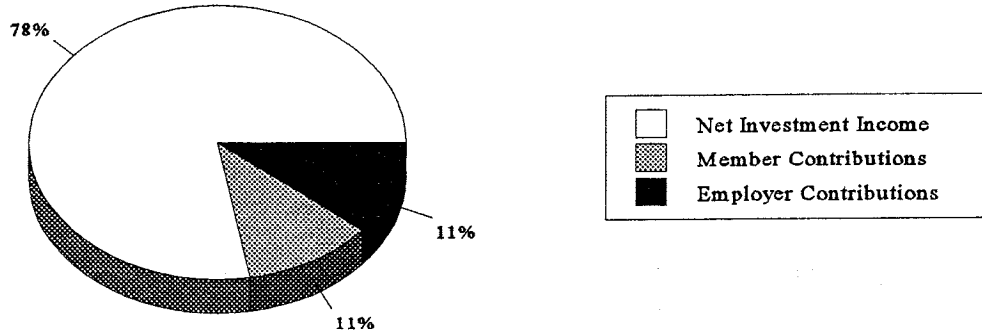


The retirement plans that the Retirement System administers are defined-benefit, contributory plans. Under a defined-benefit plan, benefit levels are pre-determined and the employer contribution rates are periodically adjusted based on retirement system earnings and liability experience to make sure enough money will be available to pay those benefits.

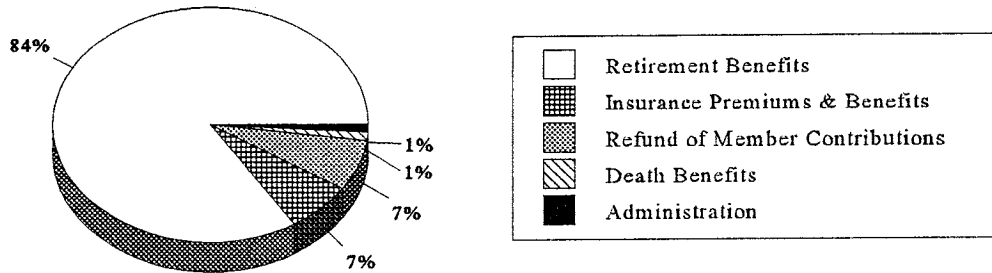
The System's administrative expenses, including employee's salaries and wages, are paid from earnings on investments. In fiscal year 2000, the Retirement System's total expenditures were about \$ 623 million. Almost \$ 592 million of that amount was for benefit payments, about \$ 25 million was spent on investment costs and about \$ 6 million was spent on operating costs.

The following charts show the relative sources and uses of operating funds for fiscal year 2000.

**KPERS Operating Income**  
FY 2000



**KPERS Operating Expenditures**  
FY 2000



As the chart shows, most funding for benefits comes from net investment income. The member contributions come from employees contributing 4% of their salary to the plan. The employer contributes an amount that varies each year. In fiscal year 2000, the State contribution was 4.19% of employee salaries for the first 9 months and 3.59% for the last 3 months. Nearly all of the operating expenditures are for benefits.

**How does the Kansas Public Employees Retirement System plan to implement its investment responsibilities for tobacco settlement moneys, unclaimed property receipts, and other funds, and is that likely to excessively dilute the System's attention to its investment responsibility for retirement moneys?**

The Retirement System was recently assigned the investment responsibilities of three funds that consist of non-retirement money. K.S.A. 38-2104 established the *Kansas Endowment for Youth (KEY) Fund* during the 1999 legislative session. This fund was established with the tobacco settlement moneys solely to provide an ongoing source of investment earnings available for periodic transfer to the Children's Initiative Fund. K.S.A. 75-5321a established the *Senior Services Trust Fund* during the 2000 legislative session. This fund exists solely to provide income to the nursing facility services payment program, the home and community based nursing facility waiver program and the income eligible (home care) program. The *Treasurer's Unclaimed Property (TUP) Fund* was established to provide investment earnings available for periodic transfer to the State Treasury for the credit of the State General Fund. During the 2000 legislative session, management of the investments in this fund was transferred to the Retirement System. Each of these three funds also were established to cover the reasonable expenses incurred to provide the income transfers.

To answer the above question, we requested a memo from the Retirement System summarizing their responsibilities and strategies for investing non-retirement moneys. The memo was prepared by Rob Woodard, Chief Investment Officer and Joan Hancock, Interim Executive Secretary and Legal Counsel. We were also provided with investment policies for each of the non-retirement funds. We also decided to determine how other retirement systems manage non-retirement moneys. To do this, we sent letters to 14 other State Retirement Systems or Investment Councils. Eleven states responded, which were Colorado, Illinois, Missouri, Nebraska, Oklahoma, Oregon, South Dakota, Virginia, Washington, Wisconsin and Wyoming.

The consideration of the legal and practical issues of centralizing money management with state government is essential for any new investment assignments given to the Retirement System. The System has developed a significant and successful infrastructure for the management and coordination of trust investments, which imparts significant economies of scale. There are many opportunities to extend these economies to other applications within state government beyond the System. To do so, however, requires a concurrent recognition of the autonomy and flexibility necessary to operate successfully.

**Centralizing Money Management within State Government Raises Some Legal and Practical Issues**

Many states have realized the attraction of centralizing investment management duties. Investment management is essentially a scale business where economies are realized on the marginal dollar managed. Investment management of government assets and enterprises can be done cheaper and more efficiently when common needs are aggregated.

Some states have developed state investment boards or councils to perform investment management assignments. These assignments may include retirement assets, employee benefit pools, trusts and endowments or practical applications like bond proceeds or idle funds. The attraction to this approach is that the board or council can be adapted to provide for whatever might be the source or nature of the assignment. Whether existing as a state agency or exclusive of the state, the board or council operates as a captive investment management firm with the state, cities and municipalities and state agencies as its clients. Expenses associated with the execution of the assignments are simply charged back to the entity or pool.

In Kansas, there is no specific entity to provide broad investment services to government. For instance, the Retirement System manages retirement assets, the Pooled Money Investment Board manages the state idle funds and the Department of Transportation manages their own bond proceeds. With the advent of the Senior Services Trust Fund and the KEY Fund, and with the decision to more actively manage the State Treasurer's unclaimed property receipts, the Legislature selected the Retirement System as the entity best suited to provide management services.

**The legal issues of diverting Retirement System officers and trustees from Retirement System duties need to be considered.** The legal issues that arise for the Retirement System are pursuant to the federal Internal Revenue Code, Kansas statute, and the common law of trusts. The federal Internal Revenue Code, at section 401(a), provides that a qualified retirement plan must be:

*... for the exclusive benefit of employees or their beneficiaries.*

State statute, at K.S.A. 74-4921(1), regarding the establishment of the Retirement System fund, provides:

*The fund is a trust fund and shall be used solely for the exclusive purpose of providing benefits to members and member beneficiaries and defraying reasonable expenses of administering the fund.*

The common law of trusts, as set forth in the *Restatement (Third) of Trusts*, § 170 comment q, explains that it is improper for trustees to conduct any business "for the purpose of advancing an objective other than the purpose of the trust."

Assets of a retirement trust fund are not to be used for any purpose other than for providing benefits or paying for the reasonable expenses of administering the fund. This legal mandate is true even when non-retirement assignments are performed for the benefit of the significant single employer or grantor of the retirement trust (such as the State).

In response to this serious legal problem, the Legislature provided language, in each of the previously cited statutes, to allow the Retirement System to recover its expenses for the management of non-retirement assets by means of assessing a reasonable fee against the fund being managed. This assessment and recovery plan, however, does not work out in fact as it was anticipated to do in theory. Although the System charges a fee against the funds, it has no way to recoup the time, manpower and other resources expended in managing the additional funds. Even though the money for managing the additional funds flows to the bottom line of the retirement fund, the System administrators do not automatically receive control over those funds. System officials believe that

the System's resources could be diverted from their legally exclusive mission and the System's members could suffer an unrecouped loss of potential services.

The Retirement System does not receive any general revenue funds, therefore expenditures come straight from the retirement trust. In the common law of trusts and as stated in the statutes at K.S.A. 74-4921(1) and (2), trustees have the duty and authority to "defray the reasonable expenses of administering the trust." But, in Kansas, it is not the Board of Trustees but the Legislature that decides on annual expenditure limitations for the retirement trust fund, each year defining explicit amounts and uses of trust assets. Thus under this arrangement, the System has been given no immediate ability to replace expended resources with the external fees it generates.

During the fifteen-month lead-time embedded in the budget preparation cycle, there is no way for the Retirement System to replenish its budget. The System requested the State Finance Council to remedy this situation by providing for an immediate increase in the System's expenditure limitation, contingent on the realization of non-retirement asset management expenses and related revenue. So far, the State Finance Council has not considered the issue. Absent some specific mechanism to replace the expended resources, the System may not be able to provide the extra management functions without violating the "exclusive benefit rule" that governs all qualified retirement trusts. System officials believe that if the System is forced to utilize its budget, such that some tasks necessary to the administration of the retirement assets are no longer funded, or that resources paid for by the System are redirected, a violation could occur. That is why the System requested and was granted the ability to recover the expended resources. However, the System is now requesting the ability to spend those recovered amounts.

**The decision to assign additional duties to the Retirement System raises many practical issues as well.** The first issue relates to resources: Any new assignments create additional work and require additional resources. Economies of scale in investment management are not due to the fact that additional dollars are managed for *free* but rather that the marginal additional dollar managed *costs less* than the previous one.

This further presupposes two conditions. First, that the objectives and applications of the money being managed are common across assignments. In other words, if a money management firm has expertise and ability in a specific application, it should be capable of supporting an extension of that expertise to like assignments. Second, if the applications are not specifically of like kind, the money management firm must have the resources to develop the systems, procedures or expertise to extend into this new application.

The second issue relates to the individual fund strategies. The statutory prudent-expert standard (a specific provision contained in each bill assigning a new fund to the Retirement System) in fact and in law requires that an informed and differentiated approach be taken relative to each assignment, based on distinctions in the particular fund's time horizon, liquidity needs, and other elements making up the specific investment profile. The following is a description of each fund assigned to the System and their fundamental differences.

**Retirement fund:** The time horizon is perpetual. The objective is long-term average returns in excess of the actuarial discount rate. Real growth is funded through increasing contributions. Failure to reach the objective is remedied through additional

contributions. Future cash flows are highly predictable. The investment strategy involves a diversified portfolio containing domestic and international equities, all types of fixed income and less liquid private assets like alternative investments and real estate.

KEY fund: The time horizon is short for the next few years, then becomes more long-term oriented. The objective is to generate a sufficient amount of cash to fund the annual transfer. Real growth is expected but may not necessarily be funded. Failure to reach objectives reduces money available for social programs. Future cash flows are contingent and subject to significant and unforeseen change. The likely investment strategy involves heavy short-term domestic fixed income emphasis, shifting to balanced investments as the fund builds, subject always to year-to-year cash flow requirements, as defined in the statute.

Senior Services Trust Fund: The time horizon is short. Cash flow is the primary objective. Real growth is desired, but must be compatible with current cash flow needs. Failure to reach objectives reduces money available for specific senior programs. Future cash flows are contingent and unpredictable. The likely investment strategy is domestic fixed income oriented with some allowance for inflation protection via real-return instruments.

TUP Fund: The time horizon is long. Cash flow to meet defined bond principal and interest pay dates is critical. Future bond issues will also require support, so an ability to synchronize interest rates on future indebtedness is critical. Failure to reach the objective would require other general fund money to be used to cover the bond payments, which could create broad budgetary issues. This money remains subject to the claims of individuals who present proof of entitlement. Since the money does not belong to the State, any permanent principal losses must be replaced. Therefore, stability of principal value is critical. Cash flows are reasonably predictable, but are subject to claims on the fund from the public. The likely investment strategy is a customized schedule of fixed income investments to immunize the bond payments, plus some structured (controlled) opportunity for long-term real growth, potentially utilizing controlled domestic equity strategies.

The third issue relates to contracts with the Retirement System's current outside investment managers. In some areas where the System could utilize a common source for the management of funds, some practical restrictions and many of their investment manager agreements preclude the use of System accounts or arrangements for non-System or non-retirement qualified assets. System officials believe that they will continue to be in a position to exert some relational leverage over their outside investment managers, but will be required in many circumstances to negotiate separate deals or make separate arrangements for the non-retirement assets.

The fourth issue relates to the coordination of information with several other agencies. In addition to the differences in strategy and application, the management of these funds demands coordination between agencies. These efforts are time-consuming for numerous employees of the Retirement System. The KEY Fund activity must be coordinated between the System fiscal personnel and the personnel of the recipients of the fund (*i.e.*, SRS) and the Division of Budget. The Senior Services

Trust Fund activity must be coordinated with the Department on Aging. The TUP Fund must be coordinated with the Treasurer's office as well as the Kansas Development Finance Authority (K DFA) and the Division of Budget.

Another issue relates to the many required reports to interested parties. Beyond the coordination of cash flows, the Retirement System is required, by statute, to produce statements and reports on a quarterly basis (or as requested), for each fund, to the various interested parties. Interested parties to whom the System personnel must provide reports, as specified in the various statutes, include:

- the Governor,
- the Legislature,
- the Director of the Budget,
- the Director of the Legislative Research Department,
- the Chairperson of the House Committee on Appropriations,
- the Chairperson of the Senate Committee on Ways and Means, and
- the Treasurer.

From a practical perspective, the System will also, of necessity, produce reports and provide information to the Department on Aging and the K DFA.

Finally, the last issue relates to the development of systems and procedures. Assuming that the Retirement System has sufficient, but not excess, resources in the form of budget and personnel for its duties to the System, the development of systems, procedures or expertise and the coordination and reporting of the assignments implies the following:

- The ability to add personnel so as to absorb added workload (and not reduce attention to the Retirement System).
- The ability to expend and subsequently recover direct and indirect expenses associated with these reports.
- The ability to independently procure the services of outside managers or service providers by contract as necessary.
- The ability to adequately and equitably compensate existing personnel for additional responsibilities. (No current position description within the System contemplates the management of assets for any entity beyond the System.)

At the present time, none of these basic abilities exist.

The desire to realize economies and synergies through the Retirement System has created the assignments, but not the resources or operational flexibility practical to carry out those assignments. As a consequence, the System officials believe one of three things could happen:

1. The System executes the assignments, utilizing existing budget and resources to do so, in violation of the sole and exclusive purpose doctrine.
2. The System outsources the assignments, reducing to the greatest extent possible its involvement in the management and reporting duties and maintaining its current exclusive focus on retirement assets.
3. An arrangement is made to allow for the application of revenues generated from

non-retirement management assignments to the budget of the System and for the statutory recognition of the Trustees fiduciary authority to autonomously contract for services.

The only real options are numbers two and three. Option two would not completely eliminate the resource issue, as there will still be considerable time and resources expended in the search, engagement and monitoring of the external manager(s), as well as in the coordination of flows and information to the other participants. Since outsourcing all aspects of asset management effectively eliminates the realization of most synergies or efficiencies, the assignment of non-retirement funds to the System may need to be reconsidered.

Assuming that arrangements for option three were available, the System would set out to constructively invest the separate funds so as to meet the objectives and satisfy any constraints. This would likely occur primarily through internal management efforts, given the unique and specific nature of the assignments. Once the KEY Fund assets were stabilized, the System would look to leverage existing relationships to build a long-term real return portfolio that would likely include some equity exposure. Likewise, the System would probably contract with external managers to develop a structured (risk contained) equity exposure for the TUP Fund once the financing arrangements for the Capitol restoration project were completed. The System would utilize the services of its existing investment infrastructure, including the custodian and the consultants, through separate contractual arrangements.

### **The Retirement System is One of Only a Few Retirement Systems That Invest Non-Retirement Moneys.**

Of the states that we sent letters to, only the Virginia Retirement System invests non-retirement moneys. Five of the retirement systems do not invest their own retirement funds. That responsibility has been assigned to an Investment Council or the State Treasurer who may or may not invest non-retirement moneys. The other five retirement systems do not invest any non-retirement moneys.

**Virginia** The Virginia Retirement System is responsible for managing the investments of the Commonwealth Health Research Fund. Personnel of the System work directly with the Commonwealth Health Research Fund Board to determine the appropriate asset allocation mix and then the System implements that allocation via externally managed index funds in commingled accounts. This allows the System to negotiate extremely favorable fees for the management of this smaller pool of assets by utilizing existing relationships with external managers of the larger defined benefit retirement plan. The System charges the Commonwealth Health Research Fund for their services, which includes the Chief Investment Officer's time, time spent by the investment staff conducting due diligence on the external managers and time spent by the accounting group in recording all of the transactions, preparing the year-end entries for the State's comprehensive system, processing the fees and facilitating the transfer of money into and out of the investment accounts.

**Nebraska** The Nebraska Investment Council manages the retirement funds of the Nebraska Public Employees Retirement System along with the State's operating cash, seven general endowment funds and five trust funds.

The Council invests the State's operating cash in three forms:

1. Short-Term Portfolio consists of commercial paper and other money market securities with a maximum maturity of one year and an average maturity of 90 days.
2. Medium-Term Portfolio consists of U.S. Treasury and Agency securities and high quality corporate bonds with a maximum maturity of five years and an average maturity of slightly over two years.
3. Nebraska Bank Deposits consists of deposits of up to \$500,000 with Nebraska banks with an effective maturity of one month.

The assets of the general endowment funds are long-term and commingled to achieve administrative efficiencies and economies of scale. The Council's investment strategy consists of 50% domestic stocks and 50% domestic bonds. The Council hired two external portfolio managers that manage the general endowment funds. The Council also utilizes securities lending to increase income.

The assets of the trust funds are invested exclusively in fixed income securities. Because of differing contractual restrictions the trust funds are kept in separate portfolios. The Council also utilizes securities lending to increase income.

Manager fees, which comprise over 80% of total expenses, are charged directly to the associated portfolios. All other expenses are charged to the portfolios pro rata based on assets.

**Oregon** The Oregon State Treasury invests the moneys of the Oregon Public Employees Retirement Fund along with the Local Government Investment Pool, the State Accident Insurance Fund, the Common School Fund and a Short-Term Cash Fund. Investment policy is established by the Oregon Investment Council. State Funds are invested in fixed income securities.

The 1999 Oregon Legislature passed HB 2007 which will be included on the November 2000 ballot. HB 2007 would establish the Health Security Fund for the tobacco settlement money. The trust fund interest would be distributed to six recipients: county health programs, low-income housing, senior and disabled transportation, anti-smoking programs, Oregon Health Sciences University and shelter care for victims of domestic violence. The fund would be invested in fixed income with a blended return of approximately 5 percent.

The State Treasurer's Office advised the House Republican leadership to allow for investment in equities where the blended rate is over 8 percent and to consider the benefits of securitization. Securitization would protect the fund from declining revenue, bankruptcy and other negative factors that influence the tobacco industry, as well as separating the State's interest in tobacco. Neither of these issues were incorporated into HB 2007.

**South Dakota** The South Dakota Investment Council invests the retirement moneys of the South Dakota Retirement System and other non-retirement moneys. The Council is responsible for the investment of State public funds. The tobacco settlement money and unclaimed property receipts are included in the South Dakota Cash Flow Fund with other State agency funds. Per South Dakota Codified Law, State funds may be invested in (1) direct and indirect obligations of the U.S. government; (2) agencies and instrumentalities of the U.S. government; (3) direct obligations of the

State of South Dakota and any of its political subdivisions; (4) obligations consisting of notes, bonds, debentures and certificates which are direct obligations of a solvent corporation of trust existing under the laws of the U.S. or any state thereof, provided that such investments shall be rated in the four highest classifications established by at least two standard rating services; and (5) savings accounts, share accounts, certificates of deposit of banks, savings and loan associations, building and loan associations and bankers' acceptances.

Individual security portfolio limits for the Cash Flow Fund are (1) the maximum final maturity date for an individual security may be no longer than five years, (2) the maximum investment in securities of the same issuer shall be no more than 5 percent of the total Cash Flow Fund portfolio and (3) the duration of the portfolio is limited to 2.88 years.

The Council's primary objectives, in priority order, for the Cash Flow Fund are (1) to provide stable income to the State agencies through receipted income, capital gain opportunities and the control of capital loss possibilities, (2) to remain sufficiently liquid to enable the State to meet all cash requirements which might be reasonably anticipated and (3) to maximize return versus the benchmark portfolio, within the investment risk constraints, liquidity needs and cash flow characteristics of the portfolio. The benchmark is 60 percent of the return of the Merrill Lynch 1-3 Year Corporate Bond Index, 13.33 percent of the Merrill Lynch 0-1 Year Treasury Index and 26.67 percent of the Merrill Lynch 1-5 Year Treasury Index.

The annual budget for the Council is approved by the Legislature and allocated among the assets under management. The Cash Flow Fund is allocated approximately 12 percent of the budget expenses.

**Washington** The Washington State Investment Board invests the retirement moneys of the Washington State Department of Retirement Systems and a broad range of non-retirement moneys. The non-retirement moneys invested include Industrial Insurance Funds, Washington State Deferred Compensation Plan, Permanent Funds, and various Trust Funds. Resources are distributed for management of these funds as appropriate. Resources are driven by an operating budget that is enacted by the State Legislature, and are not determined by the Board.

**Wisconsin** The Wisconsin Investment Board invests the Wisconsin Retirement System investments and the investments of six other non-retirement funds. The non-retirement funds are the State Investment Fund, which offers short-term investments for state and local governments, State Life Insurance Fund, Local Property Insurance Fund, Historical Society Endowment Fund, Patients Compensation Fund and the Tuition Trust Fund (EdVest).

Each fund is actively managed by an Investment Board portfolio manager. The State Investment Fund also has an assistant portfolio manager with the Office of the Treasurer acting as the administrator for the State Investment Fund program. The portfolio managers also have additional duties in the investment area, such as serving as securities analysts for larger internal portfolios. The cost of operating the portfolios is charged against the investment earnings.

## **How does Kansas' retirement and related benefits compare to those of selected other states?**

In a number of areas, Kansas' Retirement System compared favorably to the other state systems we examined. Kansas' retirement benefit and 4% employee contribution rate are about average. Kansas also offers many of the same benefits other states do, such as disability, active member death benefits and retiree death benefits. Kansas' Retirement System compared less favorably in a few areas. Most states provide automatic cost-of-living increases to retirees, while Kansas provides only occasional increases at the Legislature's discretion. Six of the nine states surveyed provide health care coverage or a premium subsidy for State retirees. Three of those states provide free or highly subsidized health insurance to retirees. Kansas and one other state allows retirees to stay in the State health care plan at group rates, but the retiree must pay the entire cost. Finally, Kansas' vesting period is 10 years, while many other states allow their employees to become vested in five years or less.

The cost of Kansas' employee retirement benefits is very low. Its employer contribution rate of 3.99% was the lowest of the other states. The contribution is held artificially low because of the statutory limitations that the Legislature placed on annual increases in the contribution rates. The statutory limits allow an increase of .2% of payroll over the prior year for fiscal years beginning in 1996 for state and school employees. The Retirement System has a somewhat larger unfunded liability than most of the other retirement systems surveyed, but there is a process in place to amortize the liability. These and related findings are discussed in more detail in the sections that follow.

### **The Retirement System's Cash Benefits Generally Compared Favorably with Other States, but Cost-of-Living Adjustments (COLAs) were Somewhat Less Generous than Many Other States Provide**

To compare the Retirement System's benefits to other retirement systems, we sent a survey to ten selected Midwestern State Retirement Systems. Eight of those responded, which were Colorado, Illinois, Missouri, Nebraska, Oklahoma, Oregon, South Dakota and Wyoming. The Kansas Retirement System also completed the survey. Annual audit reports and information obtained from the Retirement Systems' websites were used to clarify any questions arising from the surveys.

In making our comparisons, we eliminated plans covering judges, police and fire and school employees. We did this to limit the number of comparisons. We also eliminated Colorado from some of the comparisons because they do not participate in Social Security. States that do not participate in Social Security would often provide higher employer contributions to compensate for the lack of Social Security benefits. Appendix A contains data for each of the state plans we reviewed.

**The Retirement System's cash benefits compared favorably to other states.** The following table shows the annual cash retirement benefits and the percentage paid for a worker with a final average salary of \$ 30,000 and 30 years of service. The table compares Kansas' benefits to the high, low and average benefits paid by other states' retirement systems. See Appendix A for the 30 year annual benefit for all the states in our sample.

**Annual Benefit and Percentage for an Employee with \$ 30,000  
Final Average Salary for 30 Years of Service**

<u>High</u>	<u>All States</u>		<u>KPERS</u>	<u>KPERS' Ranking</u>
	<u>Low</u>	<u>Average</u>		
\$ 18,000	\$ 13,950	\$ 15,732	\$ 15,750	3rd of 7
60.0%	46.5%	52.4%	52.5%	3rd of 7

As this table shows, KPERS' cash benefit is comparable to that of the other states. Wyoming and Oklahoma paid the highest benefit and South Dakota paid the lowest.

We also compared the annual cash retirement benefit paid to a retiree with a final average salary of \$ 30,000, 30 years of service and retired for 10 years. The COLAs had to be factored into this calculation. The following table compares Kansas' benefits to the high, low and average benefits paid by other states' retirement systems. (The number of plans in the rankings varies from the previous table because some states did not respond to the question.)

**Annual Benefit for an Employee with \$ 30,000 Final Average Salary,  
30 Years of Service and Retired for 10 Years**

<u>High</u>	<u>All States</u>		<u>KPERS</u>	<u>KPERS' Ranking</u>
	<u>Low</u>	<u>Average</u>		
\$ 21,930	\$ 18,300	\$ 19,896	\$ 18,753	5th of 6

As this table shows, KPERS' cash benefit for a 10 year retiree is below the average of other states due to their use of ad hoc COLAs, which will be discussed in a later section. Wyoming paid the highest benefit and Oregon paid the lowest.

**Paid health insurance premiums must also be considered in determining how a retirement system ranks in terms of retirement benefits provided.** Although paid health insurance is a non-cash benefit, it significantly reduces a retiree's living expenses. For example, one retirement system may provide a retiree with a monthly cash benefit of \$ 800, but provide no health insurance. A second system may provide only \$ 700 a month, but may fully pay its retirees' health insurance premiums. If cash benefits alone are considered, it appears the first system has the better benefits. But if the value of the health insurance premium paid by the second system is \$ 200 a month, it is clear the second system offers the better benefit.

We found that 6 states, excluding Colorado, made health insurance available to retirees at the State's group rates, but only 3 paid all or part of the cost of the retiree's premium. The maximum monthly premium that those 3 states paid ranged from \$ 60 to \$ 196. Kansas allows a State retiree to stay in the State health care plan at group rates, but the retiree must pay the entire cost. Of those 6 states that provide health insurance, Kansas dropped from second to third after adjustments were made to retirement cash benefits to reflect the amount paid for health insurance premiums.

**Kansas gives cost-of-living increases less often than many states.** Another issue that can affect how well off a system's retirees are is cost-of-living increases. For example, two retirement systems may provide identical benefits at the retirement date, but if one system provides annual COLAs and the other does not, within a few years, the retiree from the first system will be substantially better off than the retiree from the system that provides no cost-of-living increases.

All of the states surveyed, except for the defined contribution plan, provide some type of COLA. That information breaks down as follows:

- six states provide annual automatic COLAs
- two states, including Kansas, provide ad hoc COLAs
- one state determines its COLA based on the Consumer Price Index
- one state did not provide this information

Two of the six states providing annual automatic COLAs have on occasion provided automatic and ad hoc COLAs in the early 1990s. The reason a state would do both would be if there was good investment performance in a particular year that the retirement system's Board would want to pass on to its members. Of the states surveyed, the average annual COLA over the last 10 years has been 2.78%. Kansas' last COLA was 3% in fiscal year 1998 and prior to that it was 1.5% with a \$ .50 per year of service minimum in fiscal year 1994.

**The Retirement System generally offered the same types of additional benefits other systems offered.** Kansas is among four states that have additional defined benefit contribution obligations such as death and disability, post retirement COLAs, survivor benefits, unfunded actuarial liability and retiree health coverage. The Retirement System provides an additional contribution for the unfunded actuarial liability which is comparable to the other states that provide that contribution. The System also provides a death and disability contribution, but it was suspended by the Legislature for the last quarter of fiscal year 2000 and all of fiscal year 2001. That contribution was comparable to that of other states. Some of the states surveyed have these additional benefits but they are included in the normal cost of the regular retirement benefits and not separately identifiable.

All of the states surveyed had some form of defined contribution feature. The 457(b) plan was the most popular because each of them offered this type of plan. Three of them also offered 401(k) plans and one offered a 403(b) plan. The State of Kansas offers only a 457(b) plan. Four of the states provide a defined contribution match for their members, however the State does not provide a match.

#### **The Retirement System's Non-cash Benefits Generally Compared Favorably with Other States**

Most of the systems we reviewed offered a variety of additional benefits, such as disability coverage, active member death benefits and retiree death benefits. The individual state plans vary in size and complexity, so we are making a general comparison of benefits rather than a detailed comparison.

**All of the nine states responding to the survey pay for long-term and/or short-term disability benefits.** Three states provide both long-term and short-term benefits and five states, including Kansas, provide only long-term benefits. One state did not respond on that question. The administration of the disability benefits are an obligation of all but one of the retirement systems. Three of the systems use a third party administrator, including Kansas, to administer benefits and five

of them use System personnel. Most of the disability programs are self-insured by the systems, including Kansas, and the others insure with a third party or by fixed contributions. The majority of states, including Kansas, provide long-term disability benefits for both duty and nonduty related disabilities with a standard of disability of "any occupation".

The percent of covered payroll that a disability program costs the state's ranges from .1% to .8% with an average of .57%. The Retirement Systems' cost is .37%, well below the average. The level of disability benefits for retirement systems ranged from 50% to 75% of current salary, with an average of 58%. The System has a benefit level of disability of 66 2/3%, which is above average.

The commencement of disability coverage was about even between immediate coverage and a period of eligibility. Four states, including Kansas, provide disability coverage immediately after employment begins. The other five states have a period of eligibility before coverage begins, ranging from 6 months to 10 years with an average of 5 years. Most of the states have no waiting period during disability before benefits begin, however Kansas has a 6-month waiting period before benefits begin. The duration of disability benefits for about half of the states is the lifetime of the disabled employee, while the other half pay disability through the age of 65, including Kansas.

Disability benefits are offset by workers compensation for five of the states surveyed, four of those having a 100% offset, including Kansas. Disability benefits are offset by social security benefits for six of the states, including Kansas. Also, disability benefits are offset by other disability benefit plans for three of the states, including Kansas.

**All of the nine states responding to the survey have some type of lump sum death benefit for active members.** Each state seemed to have different calculations for the lump sum, usually based on a member's annual compensation or the member's account balance and if the death was duty or nonduty related. Eight of those states also provide ongoing monthly surviving spouse/dependent child benefits upon the death of an active member. Again, each state had different calculations for the monthly benefit, but the benefits normally lasted for the lifetime of the spouse or annuitant and normally ended for a child between the years of 18 and 23 (if a student). The Retirement System provides a lump sum death benefit for an active member equal to 150% of the annual rate of compensation for nonduty related deaths. This benefit is funded through group term life insurance. For a surviving spouse or dependent child, the Retirement System provides a \$ 50,000 lump sum benefit and a monthly benefit based on 50% of the final average salary plus the return of contributions and interest and group life insurance, if the death was duty related. The majority of the states fund the active member death benefits with contributions, including Kansas.

**All but one of the states responding to the survey have some form of death benefits for retired members.** Half of those states, including Kansas provides lump sum death benefits. The other half provide monthly death benefits to the beneficiary(ies). The lump sum amounts ranged from \$ 500 to \$ 5,000. The Retirement System provides a lump sum of \$ 4,000 and is therefore on the high end of the range.

**Employee Contribution Rates in Kansas were About Average, but Employer Contribution Rates were Among the Lowest**

During the years they work, State employees generally pay for a portion of their retirement benefits through a mandatory contribution of a certain percentage of their salaries. The table below shows the ranges of employee contribution rates for the states we surveyed.

**Employee Contribution Rates**

<u>High</u>	<u>All States</u>		<u>KPERS</u>	<u>KPERS' Ranking</u>
	<u>Low</u>	<u>Average</u>		
6.00%	0.00%	4.14%	4.00%	5th of 9

As the table shows, the percentage of salaries employees from different states are required to contribute varies widely. In one state, the plan is non-contributory and therefore the employees do not contribute to the plan. Kansas employees must contribute 4% of their salaries, which the table shows is slightly below average. If only those states requiring employee contributions are included in the calculations, the average raises to 4.66%. By this measure, Kansas' employee contribution rate is still below average.

**Kansas' employer contribution rate was the lowest of the states we surveyed.** In fiscal year 1999, Kansas contributed 3.99% of employee salaries to fund the retirement system; a very low rate compared with other states. The table below shows the range of employer contribution rates for the states we compared.

**Employer Contribution Rates**

<u>High</u>	<u>All States</u>		<u>KPERS</u>	<u>KPERS' Ranking</u>
	<u>Low</u>	<u>Average</u>		
10.00%	3.99%	7.49%	3.99%	9th of 9

As the table shows, the average employer contribution rate of 7.49% was almost double the rate Kansas paid. More discussion about why employer contribution rates in Kansas are low is contained in the following section about the Retirement System's funding.

**The Retirement System Was Not as Well Funded as Many of the Other State Retirement Systems**

How well-funded a retirement system is has to do with the assets it has available to invest so that it can pay retirement benefits to employees who are currently retired, or who will retire in the future. If a retirement system is 100% funded, that means that its assets meet the present value of all its current and future liabilities for retirement benefits. If a system is only 75% funded its assets meet 75% of its liabilities. Some systems are more than 100% funded. That means that the system has more than enough assets to cover its current and future liabilities. In systems that are far greater than 100% funded, the system generally lowers the employer contribution rate until the system's assets

decline and come more in line with liabilities. The table below shows the percentage ranges that retirement benefits are funded.

**Percent that Retirement Systems' Current and Future Retirement Benefits are Funded**

All States			KPERs	KPERs' Ranking
High	Low	Average		
113.0%	79.9%	94.6%	86.0%	7th of 9

Our comparisons show that the Retirement System was about 86.0% funded, compared with an average of about 94.6% for other systems we surveyed. In fiscal year 2000, the Retirement System's level of funding has increased to 89.0%.

**The Retirement System's lower level of funding can be attributed in part to the relatively low employer contribution rate in Kansas.** The assets a retirement system has to fund benefit payments owed to current and future retirees is a function of the employer contribution rate, the employee contribution rate and the investment performance of the retirement system. Of these three factors, Kansas' employer contribution rate was the only one that appeared to be significantly lower than in other states. As noted above, for fiscal year 1999 Kansas' employer contribution rate was only 3.99%, compared with an average of 7.49% for the other state retirement systems.

**Compared with Other States, Kansas Requires Its Employees to be Members of the Retirement System a Relatively Long Time Before Becoming Vested**

Vesting is the number of years employees must have been members of a retirement plan before they are eligible to receive a future retirement benefit. The following table shows the number of years the states in our sample required their employees to work before they became vested in their retirement plans.

**Length of Time Before Employees Can Become Vested**

Number of Years to Vesting	Number of States
<5 years	3
5 years	5
8 years	2
10 years	1

As the table shows, most states vest employees in 5 or fewer years. Kansas was the only state that requires a 10-year vesting period. This longer vesting period prevents shorter-term employees from receiving retirement benefits. The extended vesting period may also contribute to maintaining lower employer contribution rates.

## APPENDIX A

### Benefits Offered by Selected Midwestern State Retirement Systems

The following table gives details about retirement benefits offered by selected Midwestern state retirement systems. Most of this information is taken from a survey we sent to the selected states. If a state did not respond to the survey, we obtained some of the information from audit reports or other sources.

State	Type of Plan	Benefit as % of Salary			Annual Benefit For Employee With Final Average Salary = \$30,000		Provide Cost of Living Increases?
		30 yrs Service	20 yrs Service	10 yrs Service	30 yrs Service	20 yrs Service	
Arkansas	defined benefit						Yes
Illinois	defined benefit	50.1	33.4	16.7	\$15,030	\$10,020	Yes
Iowa	defined benefit						
<b>Kansas</b>	<b>defined benefit</b>	<b>52.5</b>	<b>35.0</b>	<b>17.5</b>	<b>\$15,750</b>	<b>\$10,500</b>	Yes
Missouri	defined benefit	48.0	32.0	16.0	\$14,400	\$9,600	Yes
Nebraska	defined contribution	NA	NA	NA	NA	NA	No
Oklahoma	defined benefit	60.0	40.0	20.0	\$18,000	\$12,000	Yes
Oregon	combination	50.0	33.3	16.7	\$15,000	\$10,000	Yes
South Dakota	combination	46.5	31.0	15.5	\$13,950	\$9,300	Yes
Wyoming	defined benefit	60.0	40.0	20.0	\$18,000	\$12,000	Yes

**States That Do Not Participate In Social Security**

Colorado	combination	75.0	50.0	25.0	\$22,500	\$15,000	Yes
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**Notes:**

Information as of the fiscal year ending in 1999, while bold information is as of the fiscal year ending in 1998.

NA means not applicable.

Blank spaces indicate the State made no response.

\* Consumer Price Index

State	Automatic or Ad Hoc?	Contribution Rate (%)		Years To Vest	% The System Is Funded	Health Care Available?	\$ Health Care Premium Paid By State
		Employer	Employee				
Arkansas	Automatic - 3.0%	10.00	6.00	5	113.0		
Illinois	Automatic - 3.0%	9.94	4.00	8	79.9	Yes	
Iowa		5.75	3.70	4	97.0		
Kansas	Ad Hoc	3.99	4.00	10	86.0	Yes	None
Missouri	Automatic - 5.0%	8.63	0.00	5	89.2	Yes	max of \$196/mo
Nebraska	No	NA	NA	5	NA	Yes	None
Oklahoma	Ad Hoc	10.00	3.00	8	82.3	Yes	max of \$105/mo
Oregon	Up to 2% based on CPI*	8.43	6.00	5	93.3	Yes	max of \$60/mo
South Dakota	Automatic - 3.1%	5.00	5.00	3	96.9	No	NA
Wyoming	Automatic - 2.5%	5.68	5.57	4	105.8	No	NA
Colorado	Automatic - 3.5%	8.77	8.00	5	102.7	Yes	max of \$230/mo

## **APPENDIX B**

### **Agency Response**

On November 3, 2000, we provided a draft audit report to the Kansas Public Employees Retirement System. Their response is included as this appendix.



**Kansas Public Employees Retirement System**

November 28, 2000

Brad Koehn  
Berberich Trahan & Co., P.A.  
800 Southwest Jackson Street, Suite 1300  
Topeka, KS 66612-1268

Dear Mr. Koehn:

Thank you for the opportunity to formally respond to the draft copy of your completed performance audit, Reviewing Benefits Provided by the Kansas Public Employees Retirement System.

The audit raises the question of how the System intends to implement its investment responsibilities for the various non-retirement asset assignments and what impact this will have on the management of the retirement assets. We generally agree with the audit findings and acknowledge the need to move deliberately and prudently in developing the necessary systems and procedures to accomplish these new assignments while sustaining our commitment to the System. To that end, we look forward to working with the State Finance Council in an upcoming meeting to address the immediate issues related to budget and resources. We are confident that with their help and the help and support of the Legislature the objectives of the new assignments will be met without a reduction in our commitment to the System's assets.

With regard to benefits provided, the audit report indicates that the Retirement System's benefits are average or nearly average relative to other statewide pension systems while the employer contribution rate is among the lowest in the country. This is consistent with our observations and the industry data we have collected.

I look forward to sharing a few brief comments with the Legislative Post Audit Committee at its meeting this week. As always, we will be prepared to answer any questions that members may have about the Retirement System's operations or the plans for asset management.

Our standing practice is to invite you to present all completed audits to the Board of Trustees and its Audit Committee. Accordingly, this audit report will appear on agendas for the January 19, 2001 meetings of both bodies.

Sincerely,

A handwritten signature in cursive script that reads 'Glenn Deck'. The signature is written in dark ink and is positioned above the typed name.

Glenn Deck  
Executive Secretary