

## MINUTES

### KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM STUDY COMMISSION

September 22-23, 2011  
Room 346-S—Statehouse

#### **Members Present**

Senator Jeff King, Co-chairperson  
Representative Mitch Holmes, Co-chairperson  
Senator Laura Kelly  
Representative Steven Johnson  
Representative Ed Trimmer  
William Buchanan  
Edward Condon  
Christopher Long – via telephone  
Rebecca Proctor  
Michael Ryan  
Paul Seyferth – via telephone  
Richard Stumpf  
Brian Winter – via telephone 9/23/2011

#### ***Ex Officio* Members Present**

Elizabeth Miller, Acting Executive Director, Kansas Public Employees Retirement System  
Alan Conroy, Director, Legislative Research Department

#### **Staff Present**

Julian Efird, Kansas Legislative Research Department  
Michael Steiner, Kansas Legislative Research Department  
J.G. Scott, Kansas Legislative Research Department  
Gordon Self, Office of the Revisor of Statutes  
David Wiese, Office of the Revisor of Statutes  
Daniel Yoza, Office of the Revisor of Statutes  
Connie Burns, Commission Assistant

#### **Conferees**

John Lutz, Kansas Policy Institute  
Ernie Claudel, Vice-chairperson, Kansas Coalition of Public Retirees  
Brian Thompson, President, Public Employees Association of Kansas, Inc.  
Bob Coldsnow, retired KPERS member  
Patrice Beckham, Cavanaugh Macdonald Consulting, LLC  
Brent Banister, Cavanaugh Macdonald Consulting, LLC  
Levi Henry, Director, Keeping the Kansas Promise, Inc.  
Gary Adkins, Executive Director, State Employees Association of Kansas  
Chris Huntsman, retired KPERS member

Ed Klumpp, Kansas Association of Chiefs of Police, Kansas Sheriffs Association, and  
Kansas Peace Officers Association  
Keith Brainard, Research Director, National Association of State Retirement  
Administrators  
Randy Gardner, Professor, University of Missouri-Kansas City

**Thursday, September 22  
Morning Session**

The meeting was opened by Co-chairperson Holmes. He introduced Elizabeth Miller, Acting Executive Director, Kansas Public Employees Retirement System (KPERS), as the newest member of the Committee, following Glenn Deck's retirement. The meeting was webcast live on the Internet.

**Brief History of KPERS and Public Retirement Plans in Kansas**

Julian Efird, Kansas Legislative Research Department, provided a brief history on the Kansas Public Employees Retirement System (KPERS) and Public Retirement Plans in Kansas (Attachment 1). Kansas passed legislation as early as 1911 establishing pensions for local units of government. Kansas established three state-administered retirement plans prior to 1950. The Kansas Board of Regents Retirement Plan was established in the 1920s, initially including only faculty members, though later including all employees at Regents' institutions. The State School Retirement System was established in 1941 for teachers. The State Highway Patrol Retirement Act passed in 1947 for state troopers. In 1951, the state elected to participate in social security for state employees upon adoption of a formal referendum. Local units of government were authorized by legislation to participate in social security on an individual basis after referendums for covered employees. In 1973, Legislators were authorized to join KPERS.

In 1993, major legislation enhanced the benefits of current and retired KPERS members. The enhancements were recommended by a KPERS Study Commission, the Governor, and the KPERS actuarial consultant. The 1993 legislation also introduced the original statutory budget caps that would limit the amount of annual increase for employer contributions. In addition to raising the annual rate cap for employer contribution over the years, the 2003 Legislature also authorized the issuance of up to \$500 million in pension obligation bonds for the reduction of the KPERS unfunded actuarial liability.

In 2007 legislation, a new tier for KPERS state, school and local employees was established, effective July 1, 2009. The existing KPERS members became a "frozen" tier that no new members could join.

Despite the various attempts to bring the long-term funding of KPERS under control, by 2011 the situation appeared to become worse with each passing year, as measured by the increasing gap in what government employers were paying into KPERS and what the actuary was reporting as the necessary actuarial required contributions (ARC) to fully fund promised benefits for future retirees.

The 2011 Legislature passed Senate Sub. for HB 2194 which, if implemented on July 1, 2012, would make fundamental changes in the Kansas Public Employees Retirement System (KPERS) plan for most state, school and local employees, who are members of a covered KPERS group. Implementation of the legislation is contingent upon the work of a KPERS Study Commission established by the bill, the recommendations made by the Commission, and actions required by the 2012 Legislature in addressing the Commission's recommendations.

## **Formal Charge in the Legislation Creating the KPERS Study Commission**

Gordon Self, Office of the Revisor of Statutes, briefed the members on the charge to KPERS Study Commission ([Attachment 2](#)).

The KPERS Study Commission is established by 2011 Senate Sub. for HB 2194, new section 9, and prescribed a specific charge for the Commission. There are two parts to the charge, a general charge and a more specific charge. The Commission is to accomplish the following three items:

- “The commission shall study and analyze the current KPERS retirement system and systems related thereto, and develop a viable plan to ensure the long-term sustainability of the system.”
- “The commission shall particularly study and review the advantages and disadvantages of implementing a defined benefit, defined contribution or hybrid defined benefit/defined contribution retirement benefit plan, or other plan options.”
- “The commission shall submit a report to the legislature and the joint committee on pensions, investment and benefits before January 6, 2012, with any findings and recommendations which the commission deems necessary including the recommendation of any legislation. To carry out the recommendations of the commission, one bill shall be introduced in the senate and one bill shall be introduced in the house of representatives, which such bills shall contain the exact same provisions, during the 2012 legislative session.”

## **Public Comment Concerning the Type of Public Employee Retirement Plans that Should be Considered by the KPERS Study Commission**

John Lutz, testifying for the Kansas Policy Institute, appeared before the Commission ([Attachment 3](#)). Mr. Lutz stated there are two primary constraints on the ability of the Kansas Legislature to modify existing retirement benefits under KPERS. The first is the statutory provision limiting the Legislature’s ability to modify “existing rights” of members. The second is the obligation to not violate the contract clause of the *U.S. Constitution*. Although taken in tandem, these doctrines substantially constrain the Legislature in its ability to make modifications of KPERS benefits; there are certain modifications that would seem permissible. The modifications that would seem permissible are as follows:

- New hires: the reduction or elimination of benefits;
- Possibly, the elimination of features not in place at the time of a member’s hire, but only as applied to future benefit accruals;
- Possibly, the reduction or elimination of future benefit accruals for employees who have not yet vested under KPERS’ terms;
- Changes in future benefit accruals necessary to serve an important public purpose;

- Insubstantial modifications to future benefit accruals; and
- Changes to future benefit accruals where added advantages offset the resulting disadvantages.

Mr. Lutz stated that he felt the Legislature does not need to meet each of the above stated requirements, but instead just meet any one of the requirements to modify benefits.

Ernie Claudel, Vice-chairperson, Kansas Coalition of Public Retirees, stated his concerns as part-owner in the KPERS Trust Fund and retiree ([Attachment 4](#)). Mr. Claudel believed the focus of the Commission should be on the unfunded actuarial liability, not on getting out of the pension business.

A Pension Obligation Bond would help correct this problem created by the Legislature; and he suggested that all State of Kansas retirement systems, and thus the employees, be treated the same. The KPERS retirement system does not have a permanent COLA (which 32 other states have). Health insurance is not offered and some of the recipients do not receive Social Security.

There is concern that if a defined contribution (DC) plan is adopted for the “not yet hired,” and indications are that such a program would not be adequately funded, the “working” and then the “retired” public employees would be the next to fall to the chopping block.

Brian R. Thompson, President, Public Employees Association of Kansas (PEAK), appeared before the Commission ([Attachment 5](#)). Earlier this year PEAK created a task force to study and make recommendations on KPERS. The PEAK Task Force has met many times since February, and its study group is comprised of individuals from the private sector, retired governmental personnel, and active public employees. The Task Force is working on a report it would like to present at the Commission’s October meeting. Benefits received by KPERS members have changed over the years and many actions have reduced funding for those benefits:

- 17 unfunded COLAs;
- Unfunded multiplier from 1.00 to 1.75;
- Lowering the age of retirement from 65 years old to 85 points;
- Early retirement penalties not based on actuarial adjustments;
- Mandated investments in Kansas businesses;
- Moratorium of death and disability contributions over the last decade;
- Failure of the employer to pay the actuarial rate; and
- Failure to address School group’s UAL since inception.

The report, which is still a work in progress, will make several recommendations to correct the problems that currently exist. One recommendation is to have each of the six groups work to correct its own portion of the UAL and how this can be accomplished. The Task Force also is evaluating possible changes to the KPERS Board of Trustees, which may put KPERS on solid footing.

The Task Force is evaluating a defined benefit (DB) plan versus a defined contribution (DC) plan. Each has its own advantages and disadvantages, but the Task Force has concerns about the effects on current and future retirees by changing KPERS, or adding additional tiers to

KPERS, or both alterations being considered. Other recommendations will address the ability to buy back years of service, the “double dipping” issue, future COLAs, compensation of elected state officials, and funding of the system and policies.

Bob Coldsnow, a former Kansas legislator and KPERS retiree, spoke to the Commission on the contract concept. (Written comments were not provided.)

A question and answer session followed each speaker.

Co-chairperson Holmes recessed the meeting till 1:30 pm.

## **Afternoon Session**

### **Presentation and Interaction by KPERS Actuary**

Co-chairperson Holmes introduced Patrice Beckham and Brent Banister, Cavanaugh Macdonald Consulting, LLC ([Attachment 6](#)). Projections are not intended to predict the future, but rather to show the following:

- Comparisons of alternatives;
- Unfolding trends; and
- Relative importance of various factors.

Projections may require minor simplifications:

- Example: new plan provisions are effective 1/1/14; and
- A delay to 7/1/14 is unimportant over 20-30 years.

Projections are for KPERS State/School group as two groups are combined; scenarios for closed DB plan do not reflect changes in expected return due to portfolio adjustments.

Projections are based on many assumptions:

- Future membership demographic behavior;
- Demographic characteristics of new hires;
- Continually improving life expectancies;
- Specified investment returns;
- Expected salary increases;
- All other actuarial assumptions are met in the future; and
- No changes in laws, including KPERS (unless specified), Social Security, Medicare, or tax code.

In reality, there will be deviations.

Technical Details:

- All data, assumptions, methods, and provisions are the same as in the 12/31/10 KPERS valuation (except as noted);

- All assumptions are met each year;
- Active population is assumed to be level – as people leave employment, they are replaced with a new hire;
- New hires are assumed to have same demographic makeup as recent years' actual new hires;
- Plan changes are assumed to be effective 1/1/14 (Tier 3), Tier 1 – Members hired before 7/1/09, Tier 2 – Members fired after 6/30/09; and
- Results are for calendar year valuations, rather than fiscal years.

Disclaimers:

- These are estimates – actual results most certainly will be different;
- Changes in design are likely to affect retirement and termination rates. Professional judgment has been used in setting these, since it will be 25-30 years before they are reasonably known;
- The model used is very flexible, but requires the use of approximations. When needed, a new projection of specific scenarios can be developed by running these scenarios through the valuation projection software; and
- This model and the resulting graph are for assisting the Study Commission in comparing retirement designs. Use of the model for other purposes may be inappropriate and inaccurate.

Graphs were provided on Active Membership Information, Current Plan, HB 2194 vs. Current Plan, HB 2194 vs. 2 percent DC Plan for New Hires, HB 2194 vs. Combined DB/DC plan, Employer Contributions – All Scenarios, and an Appendix reflecting a chart of sample rates for scenarios with retirement eligibility at 67 and 70.

The Commission requested additional projections on the model with HB 2194 as the base; several scenarios and plans were run for DB and DC based on age and percent of return. The Commission requested several scenarios using an amortization schedule that will smooth divergence closer to a 100 percent; and also the ability to run scenarios using a Cash Balance model for the October meeting.

**Friday, September 23  
Morning Session**

The meeting was opened by Co-chairperson King. The meeting was webcast live on the Internet.

## **Public Comment Concerning the Type of Public Employee Retirement Plans that Should be Considered by the KPERS Study Commission**

Levi Henry, Director, The Coalition for Keeping the Kansas Promise (KKP or Coalition), appeared before the Commission ([Attachment 7](#)). KKP is registered in Kansas as a not-for-profit foundation, whose mission is to educate the active participants of KPERS about their retirement and retirement security. It is composed of eight active public employee organizations:

- Kansas State Council of Fire Fighters (IAFF);
- Kansas Fraternal Order of Police (FOP);
- Kansas National Education Association (KNEA);
- Kansas Organization of State Employees (KOSE);
- American Federation of Teachers – Kansas (AFT);
- Service Employees International Union No. 513 (SEIU);
- Laborers' Local 1290PE (LiUNA); and
- Teamsters' Local 696 (IBT).

The shared goal has been to obtain a solution for resolving the KPERS unfunded actuarial liability, now estimated by KPERS actuaries to be approximately \$8.3 billion.

The conferee stated the current DB plan offered by the KPERS system is the superior method of ensuring short and long term retirement security for Kansas Public Employees and public employee retirees and protecting Kansas taxpayers from bearing the full obligation for financing public employee retirements. He urged the members of the Commission to consider the following:

- Defined benefit plans require substantially less in employer and employee contributions than defined contribution plans and, therefore, reduce the obligation of Kansas taxpayers to fund Kansas' public employee retirements.
- State and local governments are exempt from the ERISA Pension Benefit Guaranty Corporation tax, which creates a competitive advantage of offering defined benefit plans over defined benefit plans offered by private industry.
- The KPERS defined benefit plan assures a source of retirement income security for Kansas public employee retirees that will not be available under any defined contribution plan by reducing the likelihood of those retirees and future retirees relying on public assistance during retirement.
- The KPERS defined benefit plan offers longevity risk pooling unavailable in defined contribution plans and, therefore, produces superior investment returns at less operational and management cost than a defined contribution system.

The pooled investment of the KPERS defined contribution plan provides financial security for Kansas public employees, Kansas public employee retirees, and Kansas taxpayers. A shift to any defined contribution plan would weaken significantly the retirement security of 280,000 current Kansas public employees and public employee retirees, and place Kansas taxpayers in extraordinary financial risk of assuming the full financial obligation of funding the unfunded actuarial liability of the KPERS fund. The KPERS DB plan provides Kansas

policymakers with incredible flexibility in managing a large public sector workforce – flexibility not available under any DC plan without great additional expense.

The Coalition urged the KPERS Study Commission to reject any attempt to create a DC tier for new employees, as it has proven to be a risky experiment in other states, an insecure and financially risky plan that provides diminished public employee retirement security.

Gary Adkins, Executive Director, State Employees Association of Kansas (SEAK), appeared before the Commission ([Attachment 8](#)). He provided a brief background on the association which has been in existence since 1994, noting that the membership is made up of state employees who are rank and file workers, supervisory/managerial personnel, and retired state workers. The reasons behind the Unfunded Actuarial Liability of \$8.3 billion were addressed in order with their membership's positions. The stated reasons are:

- Consistent underfunding by the State of Kansas – Since the inception of KPERS, members always have paid in a fixed percentage amount. Legislatures, on the other hand, voted to reduce KPERS payments to balance budgets, the underfunding amounts to a \$2.5 billion loss to the KPERS fund.
- Legislative action capped the state's payments toward the Actuarial Required Contribution (ARC) at a less-than-adequate amount. The cap has resulted over the years in a \$2.7 billion loss to the fund.
- Legislative action brought groups with significant UAL's into KPERS.
- Legislative action implemented the 85 point plan and increased the pension multiplier from 1.40 percent to 1.75 percent.
- Legislative action resulted in making questionable investments in Kansas-based financial institutions that resulted in significant losses to the KPERS fund.
- Recent market losses significantly increased the UAL, but there seems to be a turnaround and return is better than established expectations.

The Association would like to make note that the state employees had no say whatsoever in any of the decisions causing the UAL, but they are now being forced to help fund a solution, and funding a KPERS "fix" on the backs of state employees is not reasonable. Also, the Association does not support a KPERS solution that simply limits the state's pension liability at the expense of KPERS members. The Association position on the KPERS reform:

- SEAK is opposed to any changes in KPERS until a sustainable, long-term solution is put into place for addressing the UAL, and not one that significantly increases employee contributions.
- While SEAK is not necessarily opposed to an adequately funded 401K plan for state employees, it opposes implementation until the issue of replacing contributions placed in the DC fund that would otherwise be used to offset the UAL be addressed.



- If a defined contribution plan is put into place, state contributions must be sufficient to ensure a reasonable retirement standard of living when coupled with Social Security and personal savings. The 2 percent to 3 percent match currently under discussion does not seem adequate to meet this goal.

Chris Huntsman, Topeka, believing she represents the average retired teacher in Kansas, spoke for the young teacher who does not think about retirement when first starting out ([Attachment 9](#)). Citizens want the best person teaching their children, grandchildren, and great grandchildren. Good benefits are one way to get that young person to become a teacher, and retain them as a teacher.

Ed Klumpp, representing the Kansas Association of Chiefs of Police, Kansas Sheriffs Association, and Kansas Peace Officers Association, provided comments to the Commission ([Attachment 10](#)). Mr. Klumpp stated that his testimony was informational, rather than providing recommendations for changes to the KPERS system. The Kansas Police and Firemen's (KP&F) Retirement System is designed to address the needs of law enforcement officers and firefighters and the unique physical demands of those public safety employees recognizing the need to allow aging employees to retire earlier than non-public safety employees. It is unfortunate that so many local government agencies have chosen not to provide these KP&F retirement benefits to their law enforcement and firefighter employees. It is believed that these local decisions were based on the additional costs of the KP&F plan, rather than on public safety considerations or the health and safety of older officers and firefighters placed in these physically demanding positions. As the hearings proceed with deliberations and decision making, the Commission should consider the impact of requiring public safety employees to work longer as under the regular KPERS plan rather than under the KP&F plan which allows younger retirements without an actuarial reduction in benefits.

He indicated that members understand the current system must be changed to assure a viable long range and properly funded retirement system, these changes will necessarily impact employees to some degree, especially future employees; but suggested changes do not shift a disproportionate share of risks or contribution increases to the employees and changes that minimize benefit reductions.

## **Overview of Public Retirement Issues**

Keith Brainard, Research Director, National Association of State Retirement Administrators, provided comments to the Commission ([Attachment 11](#)). Mr. Brainard stated the latest findings on retirement readiness:

- 56 percent of U.S. workers say they have less than \$25,000 in savings and investments, excluding the value of their primary residence and any defined benefit (pension) plans.
- 31 percent of workers say they will need less than \$250,000 to afford a comfortable retirement.
- 45 percent are not too or not at all confident they and their spouse will be able to save as much as they think they need, and 70 percent say they are a little or a lot behind schedule in planning and saving for retirement.
- 42 percent say they determined their retirement savings needs by guessing.

The purpose for providing a retirement plan is to achieve key stakeholder objectives. Who are the stakeholders in the public pension plans?

- Employers, who seek to attract and retain qualified workers needed to perform essential public services;
- Taxpayers, who seek the provision of public services at a cost that is fair and reasonably stable and predictable over time; and
- Employees, who seek compensation that is competitive and a retirement benefit that promotes retirement security.

Distinguishing features of the public sector work—a public employee is almost twice as likely to have a college degree than a private sector worker. More public employees work in professions that involve physical risk, such as law enforcement, firefighting, corrections, and hazardous materials. Many public sector positions are career-oriented, such as education and public safety. Public sector worker median tenure is 7.0 years compared to 3.5 years for the private sector.

Distinguishing elements of public pension plans:

- Mandatory participation;
- A benefit that reflects the worker's salary and length of service;
- Employee-employer cost sharing;
- Assets that are pooled and professionally invested; and
- A benefit that cannot be outlived.

Studies and surveys consistently show that the leading cause of private employers' decision to close or freeze their pension plan is due to the uncertainty and volatility of employer costs. Private employer pension costs are determined by federal regulation, which ties contributions to interest rates. This method for determining costs results in extreme volatility and uncertainty from year to year.

Challenges presented to employees, when a defined contribution plan is the primary retirement benefit, are as follows:

- Leakage—assets leaving the retirement account before the account holder reaches retirement age.
- Fees—the cost of a typical defined contribution plan exceeds one percent of assets annually.
- Lower investment returns—DC plans under-perform professionally managed retirement pools by around one percent annually.
- Timing—an employee who retires during a down market will suffer, relative to those who retire during an up market.
- Longevity risk—a retiree could outlive their assets.

Challenges presented to employers when a defined contribution plan is the primary retirement benefit are as follows:

- Loss of a human resources management tool.
- A pension plan is particularly helpful for retaining qualified workers needed to perform essential public services.
- Retention is key for certain groups, such as teachers, law enforcement personnel, and members of other specialized career-oriented groups.
- A pension plan promotes the human resources management objective of orderly turnover, and provides for retirement or ability to retire at an appropriate age.
- Orderly turnover facilitates workforce management objectives and can promote lower salaries.

Challenges presented to taxpayers, when a defined contribution plan is the primary retirement benefit, are as follows:

- General loss of retirement security: approximately 12 percent, for example, of the nation's workforce is employed by state or local government and 8.5 percent have a public pension plan.
- Loss of economic benefits reaches literally every city and town in every state.
- Each dollar contributed by Kansas taxpayers to public pension plans supported \$5.74 in economic activity in the state and is known as "pensionomics."
- The economic effects of public pensions are particularly pronounced in rural areas.

States that have experience with DC plans being the primary retirement benefit in the public sector are as follows:

- Nebraska found that its defined contribution plan for state and county workers was resulting in workers reaching retirement financially unprepared (switched to a cash balance plan in 2003).
- West Virginia switched its teachers to a DC plan in 1993, and then back to the pension plan in 2005 (experience with a DC plan went badly).
- Michigan state workers hired since 1997 have a DC plan. The cost of the DB plan has risen to 17 percent of pay to amortize the UAL. The state is saving money because of low participation in the new DC plan in terms of employees not making larger contributions that must be matched by the state. Most participated at the minimum required level.

- Alaska closed its DB pension plan to all new hires in 2006. (The DB plan cost has risen sharply for those who remain members).

Among the primary causes of public pension unfunded liabilities and growing costs are the following: failure to pay required contributions, establishment of benefits without ensuring a sustainable funding source, failure to manage liabilities (such as through costly benefit provisions), failure to maintain appropriate actuarial assumptions, and investment losses since 2000. All of these factors, except the investment losses, are within the control of the plan sponsor. Plans that have avoided these factors are in good condition.

A defined benefit plan is not necessarily more expensive or more risky than a defined contribution plan. It all depends on how the plan is designed.

Many states have established hybrid plans in recent years. States that have a combination DB/DC plans, featuring a reduced DB component combined with a DC plan, are Georgia, Indiana, Michigan, Ohio, Oregon, Utah, and Washington. Nebraska provides a cash balance to its state and county workers, as do the Texas municipal and county government plans. The benefits are flexible and all plans are in good funding condition.

Collective Defined Contribution plans include pension plans in which the one fixed element is the employer contribution. If actuarial experience strays from the assumption, a combination of employee contributions and benefits are adjusted to restore actuarial balance, and illustrates the flexibility available in a pension plan and that a pension plan is not necessarily expensive.

Retirement security benefits everyone. The core elements of public pension plan design promote retirement security with mandatory participation; employee-employer cost-sharing; pooled assets invested by professionals; and annualized benefits. An employer-sponsored retirement benefit should serve as a workforce management tool and old-age poverty insurance (not a wealth-generating vehicle). Government, as a large and stable employer, is well-suited to sponsor such a benefit.

## **Presentation on Defined Contribution Plans**

Randy Gardner, Professor of Tax and Estate Planning, University of Missouri-Kansas City, provided comments to the Commission regarding defined contribution plans ([Attachment 12](#)). Mr. Gardner stated that a qualified retirement plan includes the following elements:

- Employer contributions that are not subject to federal income tax or payroll tax;
- Employee contributions that are not subject to federal income tax, but are subject to payroll tax;
- Tax-deferred growth;
- Protection by the Employee Retirement Income Security Act of 1974 (ERISA); and
- Individual employee timing of income tax deduction.

Charts were provided that covered qualified pension plans – Profit Sharing plans, Defined Benefit plans, and Defined Contribution plans. Non-qualified plans are retirement plans that do not need to meet the requirements of qualified plans. The needs met by non-qualified plans are:

- Ability to discriminate in favor of highly compensated employees;
- Ability to provide a second level of benefits to executives;
- Ability to lower administrative costs to employer compared to qualified plans; and
- Benefits and contributions are not limited by qualified plan rules.

Examples of Non-qualified Plans:

- Section 457 plans;
- Salary reduction plans;
- Salary continuation plans (SERPs);
- Phantom stock plans;
- Rabbi trusts; and
- Secular trusts.

403(b) Plans – Tax sheltered annuities are retirement plans for public school employees or education organization employees and certain other tax-exempt organization under Internal Revenue Code (IRC) section 501(c)(3).

ERISA applies to employee benefit pension plans of 501(c)(3) organizations, unless employer involvement is minimal, and the employer only provides for a salary reduction agreement. ERISA does not apply to any governmental plans, include 403(b) plans for school personnel and church-related 403(b) plans.

Contributions to 403(b) plans included the following:

- Employee elective deferrals – tax deductible or nondeductible (Roth), subject to payroll taxes, limited to \$16,500 per year, plus \$5,500 per year for age 50 and over catch-up, with a combined limit that may include other qualified plans.
- Employer matching allowed.
- After-tax contributions allowed.
- All contributions are 100 percent vested to the employee.

Funds within a 403(b) account only can be invested in either insurance annuity contracts or mutual funds. Loans are permissible from ERISA plans and subject to the same rules as loans from 401(k) plans. Distributions from 403(b) plans related to employee deferral contributions only can be paid after the following events:

- Death;
- Age 59 ½;
- Separation from active service;
- Disability; or
- Hardship.

Distributions from non-elective contributions are not restricted; and distributions are taxed as ordinary income and potentially subject to a 10 percent penalty.

Under the KPERS plans:

- Members contribute 4 percent of salary;

- Contributions earn 8 percent interest if hired before 7/1/93; 4 percent if hired after 6/30/93;
- Members vest in 5 years;
- Taxed like a Roth IRA – not deductible, not taxable;
- Three or four year average highest compensation x 1.75 percent x years of service for Tier 1. Five-year average for Tier 2;
- Rule of 85 (age plus years of service) for Tier 1;
- Members receive term life insurance equal to 150 percent of income; and
- Long-term disability equal to 60 percent of salary.

Discussion and questions on the different plans, including the 403(b) plans and 457 plans followed Professor Gardner's testimony.

Upon conclusion of Professor Gardner's presentation, Co-chairperson King recessed the Committee for lunch.

### **Afternoon Session**

Co-chairperson King introduced Patrice Beckham, Cavanaugh Macdonald Consulting, LLC, who presented a report on a cash balance plan ([Attachment 13](#)). A cash balance plan is a hybrid, and has features of both a DC plan and a DB plan. A DC plan is one which provides for an individual account for each participant and benefits are based solely on the amount contributed and any income, expenses, gains, or losses in the account. A DB plan is any plan which is not a defined contribution plan.

Defined benefit (DB) plans focus on benefit security and defined contribution (DC) plans focus on wealth accumulation. DC plans include 401(k) plans, 457 plans, 403(b) plans and 401(a) plans.

### **The Basics of a Cash Balance Plan Design**

For DB plans, an assumed rate of return is used in developing the annual contribution rate. Actual experience varies from year to year from the assumed (expected) rate of return. The difference in actual versus expected experience creates changes in the actuarial contribution rate, and at times, very significant changes, either higher or lower than the prior year. The employer usually bears this risk unless contribution increases are shared with the employees.

The investment risk for a DC plan still exists, but the employee bears it all. Professionally managed DB investments typically earn approximately 1 percent more than individually managed DC plans, and generally have lower expenses.

The cash balance plan combines certain features of both DB and DC plans. The DC feature included is the value of retirement benefit that is expressed during working years as an account value. The DB features include: benefits are paid as lifetime income at retirement (lump sum may be optional form of payment); there is guaranteed interest crediting; assets are pooled and professionally managed; and employer contributions will vary depending on the actual experience compared to actuarial assumptions.

Plan design features of a cash balance plan include the employee contribution rate and the employer pay credit. The interest crediting rate is a guaranteed rate that has to be set in the plan design and additional credits when experience is good. Conversion of account value to monthly income requires an investment return assumption and a mortality assumption. Conservatism can be built into the assumptions and can provide for prospective changes in these assumptions. Partial or full lump sum payments can be offered as an optional form of retirement payment.

Cash balance plans are DB plans that use actuarial assumptions and require actuarial valuations. Valuations determine the employer contribution rates based on census data for current members, expected benefit payments, plan assets, and the actuarial assumptions. The actuarial contribution rate will vary with experience. The investment return assumption and interest crediting rate will impact the employer contribution rate.

There are two statewide cash balance plans with a longer history than Nebraska and both have been successful: the Texas County and District Retirement System established in 1967 and the Texas Municipal Retirement System established in 1948.

Ms. Beckham addressed questions from the Commission at the conclusion of her presentation.

### **Information Requested at Last Meeting**

Information was requested by the Commission on the value of KPERS liabilities if benefits were frozen (no additional benefits to be earned in the future) (Attachment 14). Ms. Beckham stated that if a plan freeze is seriously considered, then consultation with a qualified legal counsel is highly recommended.

### **Commission Discussion and Planning for Future Meetings**

Commissioners requested to be able to view the cash balance plan in the model. The Commission would like to know how many KPERS employees are leaving and staying. They would like to look at the numbers by years of service categories: 0-5 years, 5-10 years, 10-15 years, 15-20year , 20-30 years and more than 30 years. KPERS has that information for state employees. The State Department of Education will be contacted for school employee information. Information will be available for the October meeting. Previous information regarding retirement adequacy that was provided to the Legislature in 2006 will be updated and made available for the October meeting. The Commissioners also would like to see the calculations for an employee entering the system at a later age as compared to entering at age 22 and leaving at 32. In addition, the Commissioners would like to see a “stacked plan” to be added to the model for the October meeting. Requests for other information or different scenarios to review should be sent by email to Julian Efir, Kansas Legislative Research Department, by next week for review by the co-chairs.

The next meeting will be October 25-26, 2011, in Topeka. The meeting was adjourned.

Prepared by Connie Burns  
Edited by Julian Efir

Approved by Committee on:

October 25, 2011  
(Date)