

**KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM (KPERS)
STUDY COMMISSION**

FINAL REPORT

Prepared by

Kansas Legislative Research Department

December 31, 2011

Senate Ways and Means

Date: 01-31-2012

Attachment: 3

2011 KANSAS PUBLIC EMPLOYEES RETIREMENT STUDY COMMISSION

Senate

Sen. Jeff King, Co-Chairperson
Sen. Laura Kelly

House

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Rep. Steven Johnson
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William Buchanan
Edward Condon
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Michael Ryan
Paul Seyferth
Richard Stumpf
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Steve Anderson, Budget Director
Alan Conroy, Director, Legislative Research
Elizabeth Miller, Acting Executive Director, KPERS
Mary Torrence, Revisor of Statutes

Kansas Legislative Research Department

Julian Efird
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Connie Burns, Secretary

Revisor of Statutes Office

Gordon Self
David Wiese
Daniel Yoza

CHARGE

Study and analyze the current Kansas Public Employees Retirement System (KPERS) retirement system and related systems and develop a viable plan to ensure the long-term sustainability of the system. 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 option.

Approved Meeting Days: 11

FINAL REPORT KPERS STUDY COMMISSION DOCUMENT

The Kansas Public Employees Retirement System (KPERS) provides disability, death, and retirement benefits for most public employees at all levels of government, including the state, school districts, and local units. Recurring concerns about the long-term funding of retirement benefits has been an issue since major enhancements were enacted by the 1993 Legislature and the participating employers' annual funding since 1995 was less than the annual actuarial required contribution (ARC). The cumulative shortfall in employer contributions exceeded \$2.7 billion and contributed to the December 31, 2010, unfunded actuarial liability of \$8.3 billion for all plans covered by KPERS. When investment losses compounded the negative impact on KPERS portfolio assets, the issue began receiving more intense review and generating a series of legislative responses, including the establishment of the KPERS Study Commission to examine the issue and to recommend alternative solutions to the long-term funding problem.

Background

Senate Sub. for HB 2194, passed by the 2011 Legislature, and signed into law by the Governor, and established on July 1, 2011, a 13-member KPERS Study Commission to analyze and review the current KPERS retirement plan, and possibly to develop a viable alternative plan to ensure the long-term sustainability of the system. The authorizing legislation is found in New Section 9, Chapter 98 of the 2011 *Session Laws of Kansas*.

The Commission was directed to study the advantages and disadvantages of implementing alternative retirement plans, including a defined contribution plan, a hybrid plan that could include a defined contribution component, and other plan options. The Commission was required to report before January 6, 2012, on its findings and recommendations. The Commission's final report was to be delivered to the 2012 Legislature and the Joint Committee on Pensions, Investments and Benefits. The authorizing legislation required introduction of the Commission's recommendations as individual 2012 House and Senate bills. The legislation does not specify which entity must introduce the Commission's recommendations, although two identical bills must be started in each chamber of the Legislature. Either the Legislative Coordinating Council (LCC) or the Joint Committee on Pensions, Investments and Benefits has the statutory authority to introduce such bills.

The KPERS Study Commission consisted of 13 voting members and four *ex officio* members who were non-voting. The voting membership of the Commission included five members appointed by the Governor (one of whom must be a practicing Kansas attorney), four members who must be legislators appointed by the House and Senate leadership (one each appointed by the Senate President, Senate Minority Leader, Speaker of the House, and House Minority Leader), and four at-large members appointed by the House and Senate leadership (one each appointed by the Senate President, Senate Minority Leader, Speaker of the House, and House Minority Leader). The *ex officio* members identified in the legislation were the KPERS Executive Director, the Governor's Budget Director, the Revisor of Statutes, and the Kansas Legislative Research Department Director.

From among its voting members, the Commission elected two of the legislators to serve as co-chairpersons. A quorum specified in the legislation was six voting members and all actions had to be taken by a majority of all members of the Commission. Staffing was provided by the Office of the Revisor of Statutes, the Kansas Legislative Research Department, and other central legislative staff service agencies as requested by the Commission. KPERS provided

staff and received an appropriation for \$60,000 to pay for actuarial services in support of the Commission's study.

Members of the Commission received expenses, mileage, and subsistence for attending meetings. The number of meeting dates was subject to approval by the LCC in order for reimbursement to members attending Commission meetings. The LCC approved a total of 11 meeting days for the Commission. Reimbursements were paid from LCC funds appropriated for 2011 interim meetings and activities.

The KPERS Study Commission originally was authorized to meet ten days by the LCC, including: July 22, August 31, September 22-23, October 25-26, November 7-8, and December 7-8, 2011, in Room 346-S of the Statehouse. The LCC authorized an additional meeting day, if needed, to occur prior to January 6, 2012. Starting with the September meeting, the proceedings were webcast over the internet and a permanent audio-video webcast of the meetings was recorded.

The Commission was directed to accomplish the following three tasks:

- "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 particularly shall 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."

At its meeting of November 15, 2011, the LCC approved one additional meeting day, also indicating that after reporting to the Joint Committee on Pensions, Investments and Benefits, the Commission's recommendations for legislation should be introduced by the Joint Committee for consideration during the 2012 Legislative Session. The Joint Committee planned to meet the first week of the 2012 Session to consider the Commission's report and recommendations, including any proposed legislation.

Kansas Pension Law Guiding Principles

The Office of the Revisor of Statutes prepared a summary of the legal aspects to guide the Commission and to provide a legal framework in which to study the retirement issues.

- The state retirement system creates a contract between the state and its employees who are members of the system. This contract is protected by the Contract Clause of the *U.S. Constitution*.
- Based on Kansas case law, it is uncertain as to when this contract is protected by the Contract Clause of the *U.S. Constitution*, but it is probably sometime after the first day of employment and certainly by the date of vesting.

- If the Legislature makes changes to members benefits that result in disadvantages to the members, it should also give compensating advantages to those members. If the state does not give counterbalancing advantages, it is more likely that this violates the Contract Clause protections granted to employees.
- Contractual pension rights may be modified for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and, at the same time, maintain the integrity of the system. Such modifications must be reasonable, and it is for the courts to determine, upon the facts of each case, what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation.
- If the state makes changes to the pension system, it is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well.
- When dealing with existing members, the Legislature may be able to make benefit changes as long as they: are prospective in nature; do not affect already accrued benefits by members; and are for purpose of maintaining the integrity of the system, have any disadvantages counterbalanced by compensating advantages, or are small changes where the contractual rights of employees are not significantly altered.
- The Contract Clause does not prohibit small changes in the retirement system if the contractual rights of employees are not significantly altered.
- Since no contractual relationship exists with future employees, the Legislature may set up any sort of retirement system it wishes for future employees.

Members of the KPERS Study Commission

The following individuals were designated as voting members of the Commission prior to its first meeting on July 22, 2011, and the appointing authority for each member is noted. Changes in membership also are noted as to when a change occurred.

Appointed by the Governor

Edward Condon
 Christopher Long; replaced by Frederick Poccia on October 25, 2011
 Paul Seyferth
 Richard Stumpf
 Brian Winter

Appointed by the President of the Senate

Senator Jeff King
 William Buchanan

Appointed by the Minority Leader of the Senate

Senator Laura Kelly
 Rebecca Proctor

Appointed by the Speaker of the House

Representative Mitch Holmes
Representative Steven Johnson

Appointed by the Minority Leader of the House

Representative Kenneth "Ed" Trimmer
Michael Ryan

The following statutory positions were designated as non-voting (*Ex Officio*) members of the Commission.

Elizabeth Miller, Acting Executive Director of KPERS (replaced Glenn Deck on September 20, 2011);
Steve Anderson, Director of the Budget;
Mary Torrence, Revisor of Statutes; and
Alan Conroy, Director of Kansas Legislative Research Department.

KPERS Overview and Impact of Senate Sub. for HB 2194

The KPERS Board of Trustees administers three separate, statewide defined benefit plans for public employees, certain public safety officers, judges, and justices. There are almost 1,500 participating employers, including the state, school districts, cities, counties, townships, and other public employers. KPERS membership includes 279,000 members, with approximately 158,000 active, 44,000 inactive, and 77,000 retired. The three largest groups are part of regular KPERS plan, including approximately 84,000 in the school group, 35,000 in the local group, and 26,000 in the state group. Another 6,000 regular KPERS members work for other types of participating employers not included among the three largest groups. The other two defined benefit plans, the Kansas Police and Firemen's (KP&F) Retirement System, and the Judges Retirement System, include approximately 7,400 members.

In FY 2011, KPERS paid out benefits totaling \$1.26 billion, including approximately \$1.147 billion for retirement benefits, \$54 million for death and disability benefits, \$10 million for retiree death benefits, and \$50 million for contribution refunds to withdrawing members. During the same fiscal year, employer and employee contributions totaled over \$855 million. The KPERS Trust Fund and its investments grew to \$13.3 billion on June 30, 2011.

For the calendar year ending December 31, 2010, the funded status of KPERS decreased to a funded ratio of 62 percent, based on the actuarial value of assets. The unfunded actuarial liability increased \$587 million to a total of \$8.3 billion and that amount represented the shortfall, or difference between funding available and the amount of benefits promised public employees. As a consequence, KPERS and, specifically, one of its groups (the school group) has a long-term funding issue.

The KP&F and Judges plans are being funded at the actuarial required contribution (ARC) and are in actuarial balance; that is, both plans are expected to provide full-funding for the promised benefits by the end of a 40-year period through 2033. The regular KPERS plan was not being funded at ARC, but the state group and local group are in actuarial balance. The KPERS school group was not being funded at ARC, and also is out of actuarial balance, meaning there would not be sufficient resources to pay all promised benefits at the end of the amortization period in 2033.

The KPERS school group had a funded ratio of 55 percent on December 31, 2010, based on the actuarial value of assets. The funded ratio for the state group was 76 percent and for the local group was 63 percent on the same date. The KP&F plan had a funded ratio of 74 percent and the Judges plan had a funded ratio of 83 percent.

The 2011 Legislature addressed the long-term funding issue for KPERS by passing Senate Sub. for HB 2194 creating the KPERS Study Commission. The legislation included other provisions that become effective on July 1, 2012, after the 2012 Legislature takes action on the recommendations of the KPERS Study Commission as prescribed in the legislation. The legislation addressed the regular KPERS plan and the three primary groups of state, school, and local employees. The Commission was not limited in its review of KPERS to consider only these groups.

Both adjustments in employer and employee contributions for the regular KPERS plan are scheduled to be implemented on July 1, 2012. Certain benefit adjustments also are scheduled to be implemented, some of which are contingent upon a favorable ruling by the Internal Revenue Service (IRS) for elections to be held.

First, the annual cap on employer contributions for state, school and local participating employers will increase from 0.6 percent to 0.9 percent in FY 2014, and will continue to increase 0.1 percent each year until it reaches 1.2 percent in FY 2017 and subsequent years.

Second, tier 1 members will have their contributions increase from 4.0 percent to 6.0 percent and will have their multiplier increased for 1.75 to 1.85 percent for future service only. Tier 2 members will continue to have their contributions made at 6.0 percent and their multiplier maintained at 1.75 percent, while losing their automatic cost-of-living adjustment (COLA) for all service. If the IRS allows elections, tier 1 members may opt to keep their contributions at 4.0 percent and have their multiplier decreased from 1.75 to 1.4 percent for future service only. If the IRS allows elections, Tier 2 members may opt to keep their 6.0 percent contribution rate and their COLA, but their multiplier for future service will decrease from 1.75 to 1.4 percent.

Based on the anticipated changes that are effective July 1, 2012, the additional employer and employee contributions, when combined with plan design changes in benefits, will improved the long-term funding outlook and allow the regular KPERS plan for all three groups to reach ARC levels, bringing all groups into actuarial balance prior to 2033. The *Actuarial Valuation Report* of December 31, 2010, detailed the fiscal impact of the 2011 legislation and changes resulting from Senate Sub. for HB 2194, if implemented.

Professional Resources and Testimony for the Commission

The KPERS Study Commission engaged a number of in-state and out-of-state professionals to assist with the study. The expertise and variety of backgrounds the different conferees and staff brought to the study enhanced the comprehensiveness with which the Commissioners were able to review and analyze the problems associated with long-term funding of different retirement plans, including KPERS.

The KPERS Board of Trustees provided staff who gave invaluable assistance to the Commissioners. Glenn Deck, who was the KPERS Executive Director when this study began in July 2011, retired in September 2011, and was replaced by Elizabeth Miller, who previously served as the KPERS Chief Investment Officer, and assumed the role of Acting Executive Director upon Mr. Deck's retirement. Both individuals provided Commissioners with the highest caliber of professional service and support in this study.

The KPERS Board of Trustees also provided two professional actuaries to carry out many of the research tasks for the Commissioners. Currently under contract to the KPERS Board of Trustees is the firm of Cavanaugh Macdonald Consulting, LLC, with Patrice Beckham,

Consulting Actuary, and Brent Banister, Senior Actuary, engaged in providing actuarial services for the KPERS Study Commission. Ms. Beckham serves as the designated KPERS Actuary for the Board of Trustees. The 2011 Legislature added a special appropriation of \$60,000 to help pay a portion of the added expenses associated with the actuarial work for the Commissioners during 2011.

Two different branches of government, the executive and the legislative, had three staff members who served as *ex officio* Commissioners and were able to provide additional professional support to the study based on their backgrounds and state-level responsibilities. Steven Anderson, Director of the Division of Budget for Governor Sam Brownback; Mary Torrence, the Revisor of Statutes for the Kansas Legislature; and Alan Conroy, Director of Kansas Legislative Research Department for the Kansas Legislature; all responded to many requests from the Commissioners for assistance and offered insights from their unique perspectives as state policy-advisors.

The KPERS Study Commission also called upon a number of out-of-state representatives of national organizations which address retirement issues. Among the national representatives who provided support to the work of the Commissioners were Ron Snell, National Conference of State Legislatures; David Draine, Pew Center on the States; Keith Brainard, National Association of State Retirement Administrators; and Joe Nichols, a consulting actuary at McCloud and Nichols, Inc., who is a member of the American Academy of Actuaries and of the American Society of Pension Professionals and Actuaries.

The Commissioners interacted with a number of out-of-state officials in reviewing the different types of retirement plans and modifications implemented in other state plans. Utah State Senator Daniel Liljenquist; Phyllis Chambers, Nebraska Public Employees Retirement Systems; and Meredith Williams, Colorado Public Employees Retirement Association; described changes to their states' retirement plans. Commissioners expressed an interest in hearing details about these specific state plans and changes adopted by them. Later, both Oregon and Washington also were addressed. Paul Cleary, Oregon Retirement System, provided background information and answered questions about the Oregon hybrid retirement plan. Marcie Frost, Washington State Department of Retirement Systems, presented an overview of the Washington State hybrid retirement plan. In reviewing pension obligation bonds, the Commissioners heard from Frank Hoadley, the Wisconsin Capital Finance Director, who presided over issuance of \$1.5 billion in such bonds for their state retirement system.

The Commissioners also received information from representatives of the Kansas Development Finance Authority about issuing pension obligation bonds. Rebecca Floyd, Executive Vice President and General Counsel, along with Jim MacMurray, Finance Vice President, reviewed a potential \$5.0 billion bond issue for KPERS as an example for the Commission to consider.

Representatives of the investment community presented information about the administration and management of individual retirement accounts for defined contribution plans and hybrid plans. Various services were described that certain companies could provide at competitive pricing. Roderick Crane, TIAA-CREF; Bernie Heffernon, ING Group; Doug Wolff, Security Benefit Corporation; and Stuart Sedlacek, an independent investment consultant; all provided information to Commissioners about the industry.

Public Testimony on KPERS

The Commission set aside time over a two-day period for members of the public to comment about KPERS and the issues perceived by those who requested time to address the Commission. Conferees presenting public testimony and information to the Commissioners represented a variety of perspectives when the public hearing was conducted. They included

current members of the KPERS retirement plan, retired members, lobbyists for public employee groups having membership in the KPERS plan, a legal policy researcher recommending changes in the current KPERS plan, and an academician offering insights and basic facts about the different types of retirement plans. The conferees who provided public testimony on the KPERS plan included John L. Utz, Kansas Policy Institute; Ernie Claudel, Kansas Coalition of Public Retirees; Brian Thompson, Public Employees Association of Kansas, Inc.; Bob Coldsnow and Chris Huntsman, KPERS retirees; Levi Henry, active member representing Keeping the Kansas Promise, Inc.; Gary Adkins, State Employees Association of Kansas; Ed Klumpp, Kansas Association of Chiefs of Police, Kansas Sheriffs Association, and Kansas Peace Officers Association; and Randy Gardner, University of Missouri–Kansas City.

Public Meetings

All meetings of the Commission were conducted in Room 346-S of the Statehouse, Topeka, Kansas. The meetings were held on July 22, August 31, September 22-23, October 25-26, November 7-8, and December 7-8, 2011. After the first two organizational meetings in July and August, all subsequent sessions were shown by webcast. The minutes and attachments from all meetings were made available on the internet website of the Kansas Legislative Research Department. The final approved minutes and attachments will be filed and available in the Office of Legislative Administrative Services for public inspection and review.

Commission Deliberations

The Commission narrowed its scope of study and focused on certain topics in the last two scheduled meetings, November and December. Among the items related to the current KPERS plan, the Commission decided to continue reviewing specific issues noted below, as well as to recommend further study by the Legislature of other items, rather than continue its study of those issues. The Commission also engaged in reviewing alternative new retirement plan designs, assisted by the KPERS actuaries.

First, the Commission focused on studying and developing two new plan designs: a Stacked Hybrid (SH) plan and a pure Defined Contribution (DC) plan. The Commission also studied, in context of developing the two new plan designs, certain related issues Commissioners deemed important considerations. Those issues included: closing the current KPERS plan for Tiers 1 and 2, and opening an undefined new Tier 3; freezing the current KPERS plan benefits, and replacing with it with an undefined new retirement plan; hard-wiring future KPERS state funding; adjusting the KPERS 1.75 percent multiplier to a lower figure; and repealing 2011 Senate Sub. For HB 2194.

Second, the Commission identified other issues to consider separately from new plan designs involving the present KPERS plan and possible adjustments in certain statutory provisions Commissioners viewed as problems in the present plan design and its implementation. Those issues included the following: eliminating KPERS service credit purchases; refunding account balances for non-vested KPERS members earlier than five years; eliminating sick and annual leave from pre-1993 KPERS members' calculations for final average salary (FAS); extending KPERS vesting from five to ten years; addressing the calculation of legislators' KPERS retirement benefits; reviewing pension obligation bonds and bonding to reduce the KPERS unfunded liability; and removing the statutory cap on the increases in annual KPERS participating employer contributions.

Third, there were additional issues the Commission identified and recommended for further review by the Legislature, but for which the Commission decided not to give further consideration during its last meetings. The Commission adopted recommendations for further legislative study to include five items for inclusion in its final report: removing the 32 year cap on

service credit that can be earned by Kansas Police and Firemen (KP&F) Retirement System members; eliminating double-dipping; controlling or eliminating early retirement incentives; standardizing all state retirement plans, including the Regents plan, and making tax treatment consistent for different state retirement plans; and preventing spiking in the calculation of FAS when determining retirement benefits.

Conclusions and Recommendations

The KPERS Study Commission concluded its 2011 meetings on December 7-8 by adopting a number of recommendations and proposed legislation for introduction to the 2012 Legislature. Recommendations adopted at earlier meetings also are reflected in this summary as noted below. The Commission's suggested changes will not be final until the first week of January 2012 after the final report is submitted on January 6, 2012. These recommendations are:

- First, the Commission voted to introduce legislation that would create a new retirement plan for certain state, school, and local government employees on July 1, 2013, with implementation set for January 1, 2014. Coordination with the current death and long-term disability benefits plan with the new KPERS plan would be incorporated in this legislation. The new retirement plan design is a two-part plan that includes a service-based annuity and employee directed contribution plan. The legislation also would close the current KPERS plan for Tier 1 and Tier 2 members (in the state, school and local groups), but those members who are vested before July 1, 2013, would continue to be covered by the provisions of the current KPERS plan. Vesting for Tier 1 and Tier 2 KPERS members requires five years of service credit. All non-vested KPERS members, and all new employees, beginning January 1, 2014, would become members of the new retirement plan.

Non-vested members would have their employee KPERS contributions, plus accrued interest, transferred to the new KPERS plan. Members would have a one-time election to allocate how much of the money transferred will be deposited into each account option for the employee defined contribution and employer annuity contribution parts of the new KPERS plan.

The only exception for vested KPERS members would apply to legislators, all of whom would be transferred to the new KPERS plan. Any legislators who are KPERS members would become members of the new KPERS plan on January 1, 2014, whether they are vested or non-vested members. Any legislator's benefits accrued under the current KPERS plan would transfer to the new KPERS plan;

- Second, the Commission adopted two other recommendations to be introduced in legislation during the 2012 Session. The Commission recommended legislation to eliminate service credit purchases on or after July 1, 2013, by members of Tier 1 and Tier 2 in the current KPERS plan, and to repeal the annual statutory cap on participating employers' contributions for the current KPERS plan that will allow payments to increase to the actuarial required contribution (ARC) rate. Under provisions of Senate Sub. for 2011 HB 2194, the current 0.6 percent cap on annual employer contributions was scheduled on July 1, 2012, to begin increasing in stages to a 1.2 percent cap by FY 2016;
- Third, the Commission adopted a recommendation for the 2012 Legislature to consider bonding a portion of the KPERS unfunded actuarial liability (UAL), or

alternatively, bonding all of the KPERS UAL, for the current KPERS plan including the state, school, and local groups. The December 31, 2010, actuarial valuation report estimated the KPERS UAL to be \$0.9 billion for the state group, \$5.3 billion for the school group, and \$1.4 billion for the local group. The cumulative KPERS plan unfunded actuarial liability for the state, school, and local groups was \$7.6 billion, or \$0.7 billion less than the December 31, 2010, total estimate of \$8.3 billion. The total UAL included the three KPERS groups plus two other plans (including the judicial, police and fire groups); and

- Finally, the Commission adopted five recommendations for further legislative study. The recommendations included five topics: removing the 32-year cap on the maximum number of years of service credit that can be earned by Kansas Police and Firemen (KP&F) Retirement System members; eliminating double-dipping; controlling or eliminating early retirement incentives; standardizing all state retirement plans, including the Regents plan and making tax treatment consistent for different state retirement plans; and preventing spiking in the calculation of final average salary (FAS) when determining retirement benefits.

New Plan Design

The new KPERS plan is a two-part retirement plan design with an annuity contribution component paid by the employer and an employee-directed contribution component. There would be mandatory contribution rates for both the employee and employer. The employee contribution rate would be fixed at 6.0 percent of compensation, with all employee payments going to the defined contribution account of the plan. The employer contribution would be service-based and would increase annually on a graduated scale from 1.0 percent initially to a maximum 5.0 percent of compensation after eight years of service. There would be an annual increase of 0.5 percent in the employer contribution rate for each year of service completed. All of the employer contributions would be deposited in the annuity contribution account.

The annuity contribution component of the new KPERS plan would make investments that would mirror the investments held by the KPERS fund, with no employee direction as to investment choices for the employer contributions. The employee-directed contribution component is a type of defined contribution account which would be self-directed by the employee, with numerous qualifying investment options, including one option to closely mirror the KPERS total portfolio. The latter option would be used if the employee does not self-direct investments.

Earnings would be based upon investment performance for both components of the plan. No amount of earnings would be guaranteed for either account in the new KPERS plan, though no overall investment losses would accrue to the annuity contribution account as part of the plan design document.

Benefit distributions would be subject to federal retirement guidelines for each part of the new plan, including the annuity contribution component and the employee's defined contribution component. For the defined contribution component, distributions would occur through a lump-sum payment or other legally permitted schedules of payments. The annuity contribution component would provide distributions through a lifetime annuity payment, based upon the Pension Benefits Guarantee Corporation's annuity rate, the account's cash balance upon retirement, the retiree's age, and other factors as prescribed in the plan design document and permitted by federal law.

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KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM (KPERS)

STUDY COMMISSION

Minority Report

KPERS STUDY COMMISSION MINORITY REPORT

Commissioner William Buchanan
Senator Laura Kelly
Commissioner Rebecca Proctor
Commissioner Michael Ryan
Representative Ed Trimmer

The KPERS Study Commission was established under HB 2194 to study and review the current KPERS system and potential defined contribution, defined benefit, or hybrid plan alternatives. The charge given to the Study Commission was to develop a viable plan to ensure the long-term sustainability of the system. Because the recommended plan does not address the system's unfunded actuarial liability and because the recommended plan adds costs to the system while reducing benefits, we do not believe the Plan recommended by the majority of the Study Commission meets our charge.

The Recommended Plan

The recommended plan was developed and presented by Senator King, and so shall hereafter be referred to as "the King Plan." Because there seems to be a great deal of confusion, even amongst Study Commission members, about the components of the King Plan, this Minority Report shall begin with an analysis of both how the King Plan was presented to the Commission and how the King Plan will work in practice. Following that analysis, we will set forth the reasons we cannot join in recommending the King Plan to the Legislature.

Senator King's Presentation

Senator King described his plan to the Study Commission on December 7, 2011, as follows:

I would like to propose a service-based DC plan with a little bit of a different twist at the end. The service-based plan employee contributes 6 percent to the service-based DC. The 6 percent is the same amount Tier 2 currently contributes. The state would contribute into the DC plan in the initial year 1 percent. The state's employer contribution goes up ½ percent every year until after eight years the state contribution would be 5 percent and remain at 5 percent for the remaining duration of employment. Over the lifetime of the plan, that is the same as a 4 percent flat-line contribution. This creates an added incentive for retention by increasing the state contribution level.

The second benefit is there are start-up costs when you go to a DC plan. By starting the contribution at 1 percent, you give employees the chance to get a higher contribution and give the state a chance to devote more resources to unfunded liability.

The 6 percent employee contribution would be set up so that the employee could make the investment choice and use the third party administrator's investment education materials. If the employee makes no choice, the default is that funds are invested in a portfolio that mirrors the KPERS investment portfolio.

Under this concept, there is one large issue and that is the cost that comes with the DB plan closure. There are some DB plan closure costs, unless you have an

element of the DB plan that remains open so your investment stream can be consistent.

In order to do that, the last part of the proposal would be an annuitization requirement for the amount that the state is contributing to the service-based DC. You would have this one to five percent amount the state is putting in. My preference is the employee can invest that money any way they want to. There may be an IRS requirement about how the money would be invested, but the idea would be to get the same return as KPERS. Upon retirement, the money remaining in that account balance for the state's contribution would roll into an annuity. That annuity would pay out at the percentage rate that PBGC has for annuity plans.

The plan would give an annuitized benefit to state employees at a level that is higher than state employees can get in the market and it has the added benefit that the state contribution stays in the DB type plan...the portion that would be in the mandatory annuity is the only state contribution to the system.

Reasoning for and Components of the King Plan

Given how Senator King's proposal was presented, many assumed he had presented a pure defined contribution plan. For background, there are three basic types of retirement plans: defined contribution (such as a 401k or 414k, where what is known is the amount that goes into the plan), defined benefit (such as the current KPERS plan, where what is known is the benefit the employee receives at retirement), and hybrid (which contain both defined contribution and defined benefit elements).

If the current KPERS defined benefit plan was frozen and replaced by a defined contribution plan, the state would experience two financial "hits": the start-up and administrative costs for operating a defined contribution plan and reduced investment returns on the current KPERS plan. Defined benefit plans like KPERS are generally invested for the long-term, because the plan is considered to continue indefinitely with no set end date. When the plan is closed to new participants and has a definite end date, the money in the plan must be invested with that end date in mind, generally resulting in more conservative investments with lower returns.

Senator King structured his Plan to try to avoid these two financial "hits." Although the King Plan has been referred to as a defined contribution plan, and was presented as a defined contribution plan "with a twist," it is actually a hybrid plan. Fundamentally, the King Plan contains three components:

- The current KPERS Plan (as revised by Senate Sub. for HB 2194) for current, vested employees;
- A defined contribution plan (401k or 414k) for non-vested employees and new hires that will be funded through the 6 percent employee contribution; and
- A cash balance plan (what Senator King refers to as the annuitization requirement) for non-vested employees and new hires that will be funded through the state's employer contribution.

A cash balance plan is a form of defined benefit plan. Under a cash balance plan, employees are entitled to receive all of the contributions made to the plan on their behalf plus a guaranteed interest rate (which is set by the terms of the plan). The idea behind these plans is that risk is split between the employee and the plan sponsor. The plan sponsor guarantees that the employee will be protected from any loss; in exchange for that guarantee the employee

accepts a lower overall rate of return. If the plan earns more than the guaranteed interest rate and the plan overall is financially healthy, all or a portion of the additional income may be awarded to participants as a discretionary dividend. If the plan is not financially healthy, the additional income can be retained by the plan to increase the overall health of the plan (instead of being credited to participants).

Senator King indicated the cash balance portion of his Plan would have a zero percent guaranteed interest rate. So, under the King Plan, new employees would have their own 6 percent employee contribution going into the defined contribution plan. This contribution would be subject to market gains and losses. The employer contribution (starting at 1 percent and ramping up to 5 percent over an eight year period) would go into the cash balance plan. Because of the 0 percent guaranteed interest rate, the state would not be required to credit any earnings on the employer contributions to the cash balance plan.

Although Senator King referred to this portion of the Plan as an "annuitization account," it is important to recognize it for what it is: a defined benefit cash balance plan. What it really does is create a Tier 3 in the KPERS defined benefit system. Under that Tier 3, the benefit is simply the cash balance in the account, annuitized into a lifetime monthly benefit. Members of KPERS Tier 3 would receive the monthly benefit from the cash balance plan, plus a separate benefit would be paid from the defined contribution plan. Senator King did not indicate what benefit options would be available under the defined contribution plan.

The purpose of the cash balance defined benefit component is to avoid the closure costs that would result from closing the current defined benefit plan to new participants. By keeping a defined benefit component, new participants and funds can be added to the existing KPERS "pool" and the income earned on those funds can be used to improve the overall health of the KPERS system. This could not be accomplished with a stand-alone defined contribution account.

The King Plan was not Correctly and Thoroughly Analyzed

The King Plan was introduced on December 7, 2011, the next-to-the-last day the Study Commission met. Discussion and voting on the King Plan was completed in a matter of hours, despite the fact that the King Plan was different in design than any plan the Study Commission had previously analyzed. Although Senator King provided estimates on income replacement at retirement and on employer costs (based on actuarial modeling), those estimates are not accurate.

The KPERS actuaries developed the computer model used and performed the analysis with the model. The actuaries indicated that the charts and estimates presented by Senator King assumed a service based defined contribution plan where all contributions (both employee and employer) were deposited into the defined contribution plan. The estimates and charts did not reflect how depositing the employer contribution into a cash balance plan (with a zero percent guaranteed interest rate) would impact the resulting balance and benefit. The Study Commission was provided no charts or estimates that showed the anticipated impact of the defined contribution/cash balance split.

Additionally, when KPERS was asked to provide information on the administrative issues associated with new plan types, KPERS was only asked to look at two possible alternatives: a hybrid stacked plan and a defined contribution plan. Neither of these alternatives is analogous to the King Plan. Both a hybrid stack plan and a straight defined contribution plan would require administration of two components: the current KPERS component and a defined contribution component. The King Plan would require administration of the current KPERS component, the new cash balance component, and a new defined contribution component. No information from

KPERS addressing the potential administrative issues associated with the King Plan was received or presented.

One of the reasons the Study Commission rejected previous plan designs was because those designs, when modeled, did not appear to meet the need to balance cost to the state against benefit to the employee while addressing the UAL. We do not believe it is appropriate to recommend a plan that was never correctly modeled for the Study Commission or considered by the KPERS staff.

The King Plan Does Not Address the Unfunded Actuarial Liability

The King Plan contains no components designed to address or reduce the UAL. When discussing the King Plan with the Study Commission on the afternoon of December 7, 2011, Senator King said:

...there are three general aspects we are tasked to look at: the UAL, making sure that future generations of Kansans, employees, and taxpayers are not where we are now, and making sure we provide the best affordable benefit that we can for KPERS eligible employees. The Plan I talked about this morning does not address the first issue. It is not going to dig us out of this hole.

By Senator King's own admission, this Plan does nothing to address or confront the UAL. The UAL is the primary motivating factor behind discussions to modify the current system. Adopting a plan which does nothing to address the UAL is simply change for the sake of change.

By contrast, the changes HB 2194 makes to the KPERS system directly address the UAL. As Representative Trimmer told the Study Commission:

Yes, we pay a lot in to KPERS and that amount will get higher before it gets lower. That is true regardless of what system we use. The difference is we pay more in the short-term and in the long-term with the defined contribution plan. A defined contribution system, as opposed to 2194, costs us more in the short-term and the long-term and provides lower benefits to the employee. No matter what we talk about, those two things are still true. The best system we have on the table is the system in 2194 which makes us pay the actuarial required rate and will eventually lower the cost in the future, which the defined contribution plan does not do.

It simply does not make sense to add costs to the system if those costs do nothing to decrease the UAL.

The King Plan Increases Costs and Complexity

Between now and 2035, implementation of the King Plan would cost the state approximately \$1.6 billion more than the system set out in HB 2194. Between 2035 and 2060, the King Plan would cost the state \$13.3 billion more than the system set out in HB 2194. This is primarily due to the fact that under HB 2194, the UAL will be paid off by 2035. At that point, the state's cost to fund the pension system will drop to 1 percent or less; the state's obligation under the defined contribution plan would remain at 4-5 percent. So, the King Plan adds significant costs to the system without addressing the UAL. Importantly, the models that produced these numbers were based only on the implementation of a service-based defined contribution plan and do not include or consider any costs that might come from establishing the cash balance plan. Any costs associated with the cash balance portion of the proposal would need to be added to these numbers to arrive at the true cost increase.

As referenced above, KPERS did not provide an analysis of the administrative issues associated with the King Plan. However, KPERS did provide an analysis of administrative issues and costs that will arise with the implementation of a defined contribution plan or a defined contribution plan component. Since the King Plan has a defined contribution component, those issues must be considered.

The biggest issues surround employer reporting. The report KPERS provided to the Study Commission on December 7, 2011, indicates that implementation of a defined contribution plan would "require all of the 1,500 KPERS employers to make changes to their payroll and accounting systems. In particular, each employer's payroll system would need to have the capability to promptly remit and reconcile separate contribution rate elements for the payroll." The report goes on explain that, currently, KPERS performs full reconciliation of reports on an annual basis; implementation of a defined contribution plan would require this reconciliation to occur each payroll period. The KPERS report concludes, "This shift is likely to entail significant information system and other operations costs for each employer."

The report goes on to address changes a defined contribution plan would require to information systems. The report states:

A key cost component would be information technology costs, particularly during the start-up and implementation phase...implementation of a defined contribution plan would involve major changes to KPERS information systems...an increase in electronic reporting by employers would add a lot of incoming communications to our network, which may require additional servers to manage the load. Fail-over servers to protect against hardware failure of the primary devices may also be required. For employers that do not transmit information electronically, the capabilities of KPERS' web portals may need to be enhanced to handle the load of additional logins to update pay information. Significant growth in the amount of data being stored could also be expected. This growth would not only affect the need for expanded data storage capacity, but it would also have a secondary impact on KPERS' disaster recovery capacity needs.

The report does not assign a set dollar cost to the information technology needs.

One of the Study Commission's charges was to "develop a viable plan to ensure the long-term sustainability of the system." A plan is not viable if it cannot be implemented by the participating employers. The Study Commission heard no testimony from any participating KPERS employer indicating if, when, or how the required changes associated with defined contribution plan reporting could be implemented. The state and all of its political subdivisions have had budgets impacted by the economic downturn. It is not viable, or responsible, to just assume that the various KPERS participating employers will have the financial resources and time to implement such significant system changes. Additionally, KPERS itself will require additional funds to upgrade its information technology equipment. These administrative costs are on top of the billions more dollars it will take just to fund the King Plan.

It is worth noting that, currently, KPERS administrative costs per member are \$44. This cost is \$46 below the peer average of \$90, and is fourth lowest in the CEM Benchmarking study of eight-eight pension systems in which KPERS was considered. By contrast, a presentation from Nebraska showed defined contribution plan administrative costs of \$92 per member, more than double the current KPERS cost. There can be no doubt that adding a defined contribution component will bring with it significant administrative cost increases.

The King Plan does not Provide an Adequate Benefit

As discussed above, the retirement benefit modeled as part of the King Plan reflects only a service-based defined contribution plan, and does not actually show what benefit is achieved when contributions are split between the defined contribution plan and the cash balance plan. The model shows what would happen if ALL contributions (both employee and employer) were deposited in the defined contribution plan and earned an assumed rate of interest over the life of the plan.

This is not how the King Plan is set up. The employer contribution does not go into the defined contribution plan (where it would be subject to market gains and losses), but into the cash balance plan, where absolutely no return must be provided. No models or charts were ever provided to show how splitting contributions between the defined contribution plan and the cash balance plan would impact the benefit provided at retirement. However, the simple numbers, paired with industry advice, show the King Plan would have catastrophic results.

As a general recommendation, most defined contribution providers indicate an employee, near the beginning of the employment career, should invest a total of 10 percent of earned income (counting both employee contribution and employer match) in a 401k or 414k plan. This recommendation assumes the invested funds will earn, on average, around 8 percent over the employee's career (this is the rate most online, 410k calculators will apply). Under the King plan, only the 6 percent employee contribution is subject to market; no interest or earnings must be paid on the employer contributions in the cash balance plan.

The model also assumes that employees in the defined contribution plan will appropriately invest their funds to receive, on average, an 8 percent return. The defined contribution portion of the plan will be self-directed, meaning employees will choose how their dollars are allocated among the investment options provided. Finally, the model assumes employee pay will increase by 4 percent per year. Public employee pay in Kansas, quite simply, is not increasing at anywhere near that rate.

While, in theory and with the right assumptions, defined contribution plans can provide a great return, actual reality shows something different. As an example, in 1991, due to underfunding and poor investment returns, West Virginia moved to a defined contribution plan for its teachers' pension plan. The defined benefit plan was closed to new participants and a 401(k) plan was created for new hires. After 17 years, the average account balance was only \$33,944, despite a state matching contribution of up to 7.5 percent. This result led West Virginia to abandon its defined contribution plan and convert back to a defined benefit plan.

West Virginia's experience is consistent with the findings of the Employee Benefit Research Institute and the Investment Company Institute. They surveyed 20 million 401(k) participants and found the median account balance of an approximate age 60 worker earning between \$40,000 and \$60,000 per year was \$97,588. This amount would generate only around \$8,000.00 per year in retirement income if invested in an annuity.

This is the real-world result that can be expected from the defined contribution portion of the King Plan, only the resulting balances will likely be even lower since no employer match is deposited into the defined contribution plan. While the cash balance component may protect against market losses, the fact that the guaranteed interest rate is set at zero percent means the money in the cash balance account also will not grow. It is highly doubtful that the combination of a defined contribution plan and a cash balance plan that provides no interest can provide a livable benefit for public retirees. It is also neither fair nor equitable to expect public employees to accept an account that gives them no opportunity for any return.

During Study Commission debate, Senator King stated the legislation could require any earnings on the cash balance component be awarded to employees. This statement misunderstands how cash balance plans work. Because a cash balance plan is a defined benefit plan, the benefit that comes out at retirement is what must be known or defined (hence the reason a guaranteed interest rate must be set). If the interest or earnings to be awarded is unknown, the benefit is no longer defined. This is why any award of interest over the guaranteed rate is performed as a discretionary dividend; it simply cannot be required.

CONCLUSION

The King Plan increases costs to the system and reduces employee benefits while doing nothing to address the UAL. Accordingly, we do not believe the King Plan fulfills the charge the Study Commission was given to recommend a viable plan to ensure the long-term sustainability of the KPERS system.

Respectfully Submitted,

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