

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM (KPERS)

STUDY COMMISSION

Minority Report

KPERS STUDY COMMISSION MINORITY REPORT

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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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