Approved: March 2, 2000
Date

MINUTES OF THE HOUSE KANSAS 2000 SELECT COMMITTEE.

The meeting was called to order by Chairperson Kenny Wilk at 1:30 p.m. on January 26, 2000 in Room 526-S of the Capitol.

All members were present except: Representative Susan Wagle - excused

Committee staff present: Alan Conroy, Legislative Research Department
Gordon Self, Revisor of Statutes
Janet Mosser, Committee Secretary

Conferees appearing before the committee:
Meredith Williams, Executive Secretary, Kansas Public Employees Retirement System
Rob Woodard, Chief Investment Officer, Kansas Public Employees Retirement System

Others attending: See attached list.

Chairperson Wilk recognized Meredith Williams, Executive Secretary, Kansas Public Employees Retirement System (KPERS) to address the committee. Mr. Williams explained that he had hoped to address today questions primarily of an actuarial nature that were provided last week by Chairperson Wilk. After discussion with the actuary, it was decided that, because of the complexity of the issue, the actuary needed to be present when the questions were answered. Arrangements will be made to have the actuary attend a future meeting to respond to the questions.

Mr. Williams told the committee that retirement plan design debate is taking place across the country. The Board of Trustees of KPERS has spent the past year reviewing plan design issues and last Friday adopted a report that includes a series of conclusions and recommendations for consideration (Attachment 1). Mr. Williams introduced Mr. Rob Woodard, Chief Investment Officer, KPERS. Mr. Woodard was recognized by the Chair. Mr. Williams and Mr. Woodard gave an overview of defined benefit/defined contribution plan design (Attachment 2).

Questions and discussion followed.

Chairperson Wilk adjourned the meeting at 3:08 p.m.

The next meeting is scheduled for January 27, 2000.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

KANSAS 2000 SELECT COMMITTEE GUEST LIST

DATE: 1-26-00

NAME	TITLE	REPRESENTING
Don Rzoe	Lobbyist	S.E.A.K
David Dominic	Manager	VALIC
Bill Henry	Legi. Counsel	VALIC
Trish Heim	Paralegal	SBG
Dale McAllister	Asst. VP	SBG
Keith Haxton	Lobbyist	SEAK
Pat Lehman	Lobbyist	KS Fire Service Alliance
Ginny McCord	Personnel office	Dept of Ag
Dennis Beardon	PERSONNEL Office	DEPT. OF AGRICULTURE
Rob Woodard	CIO	KPERS
M. D. W. Williams		"
Jack Hawn		"
Richard Brandtner		"
PATRICIA HENSHALL	DIRECTOR OF PERSONNEL ~~JUDICIAL BRANCH~~	JUDICIAL BRANCH
Krista Gaspeich	Staff	DOA/DPS
Candace Mofhon	Staff	DOA / DPS
Karen Watney	Staff	DOA / DPS
Dennis Phillips	Sec.	KANSAS STATE COUNCIL OF FIRE FIGHTERS
Dave Sterbenz	President	Kansas State Firefighters
Ed Redmon		" " " "
Brett Round	District	Aetna Fin Serv
D. KEITH MEYERS	ASST. TO THE SECRETARY	DEPT. OF ADMIN.
Allen Humphrey	HR Manager	KCC
Mary Beth Green		KPERS

KANSAS 2000 SELECT COMMITTEE GUEST LIST

DATE: 1/26/00

NAME	TITLE	REPRESENTING
Jared Hawsin	Intern	Rep. Troy Findley
Tim Shallenburger	State Treas.	KGC
Steve Parsons		
Roger Franzke		SBG
Craig Grant		KNEA

PLAN DESIGN:
A Review of Current Public Pension Issues

Presented by the
Kansas Public Employees Retirement System

January 2000

Kansas 2000 Select Committee
Meeting Date 1-26-00
Attachment 1

PLAN DESIGN

A Review of Current Public Pension Issues

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PLAN DESIGN:
A Review of Current Public Pension Issues

Presented by the
Kansas Public Employees Retirement System
January 2000

EXECUTIVE SUMMARY

During the 2000 session of the Kansas Legislature, a number of proposals to change the benefit structure of the Kansas Public Employees Retirement System (KPERS), wholly or in part, from a Defined Benefit (DB) plan to a Defined Contribution (DC) plan will be considered. Over the last several years, the KPERS Board of Trustees and staff have studied the issues affecting public employees arising from the differences between DB and DC plans. The enclosed report contains a detailed analysis of those issues, sets forth several recommendations for legislative consideration, and conveys the following observations.

KPERS provides guaranteed benefits at a surprisingly low cost to the employer. KPERS' employer rates are among the lowest in the country while its benefits are comparable to those of other public plans around the country. Public employers in Kansas contribute less than half as much per employee to the KPERS plan as the State does to the Regents DC plan.

Unlike many DC plans but similar to most DB plans, KPERS does not provide employee direction of investments, early vesting in guaranteed lifetime benefits (it takes ten years), vesting in any portion of employer contributions (except to those who retire), or any lump sum distribution at retirement.

No one doubts that employee direction of some retirement assets is certainly desirable as an adjunct to a reliable and guaranteed DB plan. Employee direction is available now to State employees through the voluntary State of Kansas 457 Plan, which is run by a third-party administrator. Similarly, local governmental units and school districts often provide voluntary supplemental DC options for their employees. The State's 457 option could be extended to more members, could be enhanced by lowering expenses and improving the available investment options, and could be encouraged by instituting a minimal employer matching contribution.

Moreover, KPERS could be altered to provide earlier vesting, vesting in employer contributions upon withdrawal, and lump sum options at retirement. Except for the lump sum option (which can be achieved by an actuarial reduction to the monthly benefit), these alterations would have a cost. They have a cost whether they are part of the existing DB program or come with the adoption of a new DC program. Simply,

Benefits = Contributions + Investment Earnings – Expenses.

This is an equation that is always and everywhere true and cannot be avoided by changing plan designs.

The fact is that higher benefits can only be gained by higher contributions, greater earnings, or diminished expenses. There is no other way. Some who promote conversion of KPERS to a DC plan while not addressing the current low level of employer contributions get around the problem by relying on unwarranted assumptions. They theorize that governmental DC participants -- who have no advantages related to company stock or profit sharing -- will do so well as investors in the markets that the funding deficiency inherent in the State's low employer contribution levels can be cured by the employees' consistently superior investment success. This idea contains the seeds of grave danger for future Kansas retirants and taxpayers.

In sum, abandoning the low-cost guarantees of the KPERS DB plan is unnecessary to achieving any outcomes urged by DC proponents and could well be a serious disadvantage for future public employees.

No one would deny that the KPERS plan could be improved. In the areas of individual freedom and personal responsibility, wealth building, and portability and vesting, significant opportunities exist for enhancing current retirement structures. With that in mind, in this report the KPERS Board of Trustees makes the following conclusions and recommendations.

CONCLUSIONS AND RECOMMENDATIONS

In General

In supporting the best interests of KPERS members, as the Legislature considers various proposals to enhance or change the KPERS DB plan, *the Board recommends focusing on the following principles and ideas:*

- ➢ **Acknowledge that DB and DC plans each have attractive attributes and fundamental drawbacks, and that neither provides a superior cost / benefit structure under all circumstances.**

- ➢ **Agree that the most desirable objective is to encourage personal responsibility by public employees, while sustaining a reliable and predictable income-replacement ratio in retirement.**

Personal Responsibility and Freedom of Choice

The famous "three-legged stool" for retirement includes Social Security, a good pension plan like the KPERS DB plan, and personal savings in a voluntary DC plan like the State of Kansas 457 plan. One leg of the stool is weak for Kansas public employees. Therefore, *the Board concludes that*:

- **The current 457 plan is expensive for participants. Many public and private employers have more efficient and less expensive deferred compensation plans and Kansas should, too.**
- **The current 457 plan contains no low-cost, index alternatives. Adoption of lower cost investment options should be demanded.**
- **In order to leverage the economies and efficiencies KPERS enjoys in the investment arena, the State should enact legislation to involve KPERS in the 457 plan.**
- **In any event, the State should provide at least a minimal employer match to encourage employees to demonstrate personal financial responsibility through increased participation in the 457 plan.**

Wealth Building

The Board recommends enactment of changes to the KPERS plan that would offer some reasonable options for receiving at least part of the retirement benefit as a lump sum. Consistent with Internal Revenue Code requirements, such design changes could involve:

- **A reduced monthly benefit in return for an immediate lump-sum payment.**
- **A reduced monthly benefit in return for making a lump sum available to a survivor upon the member's death.**

Sample projected benefit changes and illustrative lump sum distributions for these options are contained in the report.

Portability and Vesting

The Board recognizes that workers in a more mobile workforce are interested in both earlier vesting in a lifetime benefit, and vesting in a right to receive some part of employer contributions even if a lifetime benefit is not earned or chosen. Therefore, *the Board instructed its actuary to cost out options that include*:

- **Lowering the KPERS vesting period for receipt of benefits from 10 years to 5 years.**
- **Lowering the KPERS vesting period for receipt of benefit from 10 years to 7 years.**
- **Allowing terminating employees to withdraw their own funds with current prescribed statutory interest rates plus some portion of the employer contributions made on their behalf, specifying a graduated vesting schedule for full vesting in employer contributions.**

The actuary's projected cost figures for these changes are contained in the report.

PLAN DESIGN:
A Review of Current Public Pension Issues

January 2000

I. BACKGROUND

During the 2000 session, the Kansas Legislature will consider several bills proposing some sort of enhancement or change to the current KPERS Defined Benefit (DB) plan. The proposed changes range in complexity from minor adjustments to major restructurings. All of the proposals would, to a greater or lesser extent, convert the plan to some form of Defined Contribution (DC) structure.

This report discusses some of the contentions raised by proponents and opponents of changing the State's pension plan from DB to DC. It contains some suggestions for including DC-like features within the current DB plan, presented as conceptual alternatives to the proposed changes.

In the appendix, the report contains a section on terms and definitions, a brief history of the legislation establishing KPERS, a description of current KPERS benefits, employer contribution rates for Fiscal Year 2000, a discussion of two "special groups" addressed in the retirement statutes, information on KPERS demographics, a table comparing KPERS features to those of other state DB plans, and a description of software designed by KPERS' actuary to assist in plan design discussions.

II. CONVENTIONAL WISDOM AND CONCEPTUAL MISUNDERSTANDINGS

To begin, it may be useful to dispel several oft-repeated statements that are either incomplete or erroneous or both. The most common of these statements are as follows:

- **"DC plans are less expensive."**

This is not true. Expenses arise in two major areas: investment management and benefit/account administration. Investment management within a DB plan is less expensive, on average, because all accounts are aggregated and enjoy economies of scale. Account administration can be more or less expensive in either plan, depending on the options and features provided to the participants.

While generally it is not true that either plan type is necessarily cheaper or more expensive than the other, DC plans are usually more expensive than DB plans. Oddly, though, the conventional

wisdom is that DC plans are cheaper. This perception evidently exists because of who pays the tab. Employers are usually the ones considering the change, and for many of them the cost of a DC plan might be cheaper.[1] In a DC plan the employee pays the costs. In DB plan the costs (lower because of the economies of scale and subsidized by retention of employer contributions related to early leavers) are absorbed in the plan's performance figures and, to the extent needed for actuarial funding of the promised benefits, must be made up by employer contributions. Whoever pays the investment management costs, the inescapable fact is that benefits paid cannot, under any plan, exceed the following equation:

Benefits = Contributions + Investment Earnings – Expenses.

- "DC plans create greater wealth for the participant."

Some DC plans do very well for participants. But again, no plan can pay out in benefits any amount that exceeds contributions plus investment earnings minus expenses. Any proposal that envisions Kansas continuing its lowest-tier effort among the 50 states in terms of employer contributions, plus increased investment expenses related to managing thousands of accounts individually, can not seriously be predicated on an expectation of creating benefits for retirants that will exceed those they now have.

Some DC accounts contain a generous employer match, which raises effective investment returns. Some private-sector DC plans have an option to purchase employer stock. Some private-sector DC participants have received extraordinary returns due to the corporate equity opportunity (Wal-Mart or Sprint employees, for example). These advantages are not available to Kansas public employees.

Also, the recent sustained bull market has created superior returns on equity or stock investments within some accounts. The historically unprecedented returns from the stock market over the last decade have nearly doubled the annual average return from the previous 60 years. But, like a driver who only considers the information available from the rear-view mirror, projecting these returns indefinitely into the future is a very dangerous operating strategy.

In generally efficient financial markets, the average gross (risk-adjusted) investment return is the same for all investors, regardless of their mode of investing. Given identical funding and investment strategies, only a difference in the amount of expense associated with investing will have a material impact on net results. Adjusting for risk by assuming that the aggregate DC investment profile will be diversified among equities and fixed income, just as a DB plan is, the primary differential in returns becomes expenses. As stated earlier, DC plans have a higher

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[1]This is not the case in Kansas, where the DB plan costs the State around 4 percent of payroll, contrasted with other states, many of which pay much more. As far as we know, the Legislature is not considering an employer contribution rate of less than 4 percent for the proposed DC plan. Paradoxically, 4 percent employer contributions to a DC plan would *increase* the cost for local units of government in Kansas, who now pay less than that. The "DC plans are cheaper" viewpoint is also shown to be incorrect in Kansas by comparing the KPERS 4% employer contribution rate with the rate for Kansas' own DC plan for Regents employees, which costs the State 8.5 percent of payroll.

expense ratio than DB plans because it is more expensive to manage thousands of small individual accounts than one large institutional account. As such, DC plans will not perform as well, on average, over time.[2] When considered in comparable time contexts, with comparable funding and investment alternatives, DC plans do not magically create greater wealth.

- **"Converting to a DC plan will eliminate or improve the unfunded liability."**

This is not true. What is true is that a DC plan, by design, will not create any unfunded liability. It can't, because no future benefits are promised, no past service is rewarded, no liabilities for underfunded local or archaic statewide plans are assumed, no veterans' perks or other socially attractive packages are given away. Simply, what the employer contributes to a given employee's account each payday is the sum total of the employer's retirement responsibility to that employee, forever. But, by the same token, neither can instituting a DC plan eliminate the existing unfunded liability of the DB plan. It would neither increase DB contributions nor decrease the future obligations arising from previously guaranteed DB plan benefits.

In contrast to hopes of doing away with the DB plan's unfunded liability, switching to a DC plan could exacerbate the predicament. There is a foreseeable problem associated with transfers of current employees out of the DB into a DC plan. A DC plan would likely be most attractive to younger workers. As these employees transfer out of the DB plan, there would be an impact on the ongoing costs associated with the DB plan. It is true that the present value of the younger transferring workers' future-benefit claims and the value of their accounts may be minimal, but the impact of their departure from the DB plan is not. This is because some of the cost of the guaranteed DB plan benefits is funded by the plan's retaining the employer contributions and earnings on the accounts of early leavers. This significant source of funding is lost when the rapid-turnover population has transferred out of the DB plan. The lost funding for the remainder of the DB plan would have to be replaced, presumably through increased contributions by employers (employee contributions cannot be increased, according to Kansas Supreme Court cases, unless the increase is accompanied by an increase in benefits).

- **"The most attractive alternative for employees is always a DC plan."**

This is not true. The very best alternative for employees is to have both a DB and a DC plan. This is because in many ways, DB and DC are complementary. Whereas a DB plan may demand longer vesting, less flexibility and little individual control, it does provide a solid, guaranteed lifetime benefit. A DC plan, while not guaranteed, provides an opportunity to share in the long-term appreciation of investment assets, to exercise self-direction over investments, and to customize retirement and financial planning to serve individual needs. Neither plan provides all the answers, and both have structural shortcomings. Together, however, they provide the best of all worlds for the majority of employees, regardless of financial status, investment knowledge, self-discipline or personal circumstance.

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[2] Although the impact of expenses on investment returns and ultimate retirement benefits is a function of many factors, a general rule of thumb suggests that *for each 1 percent increase in expenses during the accumulation phase the final retirement benefit is reduced by 20 percent.*

The State of Kansas currently offers a type of defined contribution plan, known as deferred compensation, to its employees by means of a voluntary supplemental plan under Internal Revenue Code section 457. Many local units of government also make a 457 plan available to their employees. And numerous school districts make a 403(b) plan (tax-sheltered annuities) available to their employees.

III. MAJOR DB / DC ISSUES

- **Individual Freedom / Elimination of Government**

Initially, of course, in a pension plan for government employees, government involvement cannot be eliminated. Government officials design the plan, partially fund the plan, oversee the plan, and make changes to the plan. Even if plan administration is outsourced, which is not necessarily a given in conceiving of such a plan, the recipient of the outsourced contract is selected by government officials.

Nor will any perceived governmental "conflict of interest" be resolved by eliminating a board of trustees from the investment process. It is urged by some that a conflict arises when an arm of the government sues a company whose stock is held in the pension fund of that government's employees. These voices assert that the conflict would cease to exist if individual workers made their own investment choices. Of course it is true that the Attorney General may sue a company in whose stock state employees have a pension investment. But whether the stock has been selected by a board of trustees or by an individual state employee does not alter the interests involved or resolve any conflict between them.

Many proponents of DC plans argue that by creating more individual control, DC plans increase individual freedoms and relieve taxpayers of the financial burden of guaranteed pensions for government employees. There is an element of truth to these statements, but like most of the debate, an examination of all sides of the issue is required for a full and accurate understanding.

A self-directed DC plan does provide freedom of choice to individual participants. As an individual investor, one may choose the investment mix, reap the benefits of any excess net returns, shape one's retirement benefit to fit other personal financial circumstances, and generally control one's own retirement destiny. In exchange for these liberties, an individual must also pay the costs of administering and investing the account, assume responsibility for making informed and sufficient choices as to investment strategy, and accept the risks associated with poor results and adverse actuarial experience.

Many people, given sufficient information, will do a good job. Unfortunately, some risks that can be easily absorbed when spread across a group can be devastating when assigned to individuals. Some individuals within the group will routinely be poorly equipped to make sufficient planning decisions during their working years. Others will routinely make poor long-term decisions at retirement if provided a lump sum distribution. After retirement, all retirees will potentially be forced to deal with other challenges, such as a collapse in asset values, a decline in purchasing power or an increase in longevity.

A wholesale shift to a DC format may create eventual additional costs for the state or federal government in the form of safety nets and/or entitlements. For good or ill, government is often called on to help those with nowhere else to turn. There is the potential for a small but recurring portion of the retired public-employee population to suffer economically (and a potentially larger portion to suffer periodically) if the guarantees inherent in a DB plan are removed. This creates a counterpoint to the notion of reducing government. Although a private employer may well be able to walk away from an economically ill-equipped population of retirees, the government would not. Because government is the provider of the last line of economic security for its constituents, the interests of government may not be better served in the long run by switching public employees to a poorly funded DC plan.

- **Portability**

The term portability has been used in various contexts, and usually involves vesting and transferability. Vesting is a function of plan design, and the provisions need not be significantly different whether the design is DB or DC. Portability of retirement assets from one employer plan to another is governed by federal law.

Vesting. Vesting may be immediate (as is always the case with employee contributions) or deferred. Currently, within the KPERS DB plan, employees do not vest in (gain a guaranteed right to or claim on) the employer portion of their benefit until they have been employed for ten years – and even then, they must retire on monthly benefits to share in the employer contributions. Thus, KPERS members who withdraw from the plan take with them only their own contributions to the plan, plus an annual credit of interest. The interest credited is often less than the fund's earned rate.

Employees typically do vest sooner in a DC plan, although nothing in the laws governing DB or DC plans requires that this be so. With earlier vesting a shorter-term employee, whether in a DB or DC plan, may receive upon termination some or all of the employer portion of the payments into the retirement account as well as the earnings thereon.

A longer or shorter vesting schedule is important primarily to two types of employees. One is a set of systemically short-time employees who tend to be employed for less than the typical five to ten year vesting schedule of DB plans. The other is the highly mobile professional employee, whose career orientation may create a higher level of expected turnover and thus lower tenure. Short time employees may be so for different reasons. The reasons may be structural (low-wage jobs with high turnover), or very job-specific (employment for a term certain, as with elected officials), or demographic (younger employees less settled in a career). Some believe that the modern economy is comprised of a much more mobile workforce, and people consequently will hold a greater numbers of jobs across their working lifetime.[3]

[3] The assumption that most workers will be "happily mobile ever after" is less valid as time goes by and the workforce rapidly ages. Every 8 seconds for the next ten years, a baby boomer turns 50 (that's 11,000 people per day). *The Atlantic Monthly* states: "By 2025, the proportion of all Americans who are elderly will be the same as the proportion in Florida today. America, in effect, will become a nation of Floridas." There is a dramatic shortage of younger replacements as baby boomers age. Employers will need to keep their older workers. Older workers greatly

For either a DB or DC plan, the plan sponsor has the option to determine the length of time and rate at which employees may vest in the employer portion of the benefit. This option is restricted for private-sector plans in that the federal Employee Retirement Income Security Act (ERISA) dictates certain required vesting-schedule options from which the plan sponsor must choose. Public-sector plans are not governed by this ERISA requirement, and are free to select any vesting schedule. There is no more prohibitive vesting period in the pension community (other than in police and fire plans) than the ten-year vesting requirement for KPERS. This could be changed. The System's actuary has estimated the costs of shortening the vesting schedule and creating greater portability of benefits in this regard. These estimates are shown on pages 12 and 13 of this report, below.

Transferability. The federal Internal Revenue Code effectively sets the rules regarding the ability to make a tax-favored transfer of the balance from an employee's current plan to another tax qualified plan such as an IRA or a company sponsored 401(k) upon changing jobs.[4] From a 401(a) DB plan such as KPERS, tax-free transfers (called rollovers) are allowed to and from a number of types of plans, including 401(k) plans and IRAs.[5] However, transfers between 401(a) plans and 403(b) plans are not allowed.[6] From a 457 plan such as the voluntary State of Kansas 457 plan, a tax-free rollover may only be made to another 457 plan. Legislation has been pending in Congress to add flexibility to transfers of 457 assets, and generally to decrease the restrictions on rollover opportunities as to all employer plans.

- **Likelihood of Vesting**

DC proponents make an argument that DB plans are somehow less valuable than DC plans because too few employees vest. As stated above, vesting in a DB plan does not have to be shorter than vesting in a DC plan. But if more employees have an increased right to claim the employer portion of contributions to the plan, the plan's liabilities are higher. The State of Kansas has kept the ten-year vesting period in the DB plan in order to keep plan costs down. Whether the vesting period is shortened in the DB setting or the DC setting, it has a cost. Simply, the percentage of people who vest is not a function of DB versus DC plan structure. It is a matter of the philosophy of the plan sponsor and how much the plan sponsor is willing to spend.[7]

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prefer stability over mobility. According to a Watson Wyatt study, most workers above age 45 prefer DB to DC as the best plan design for their needs.

[4] In mentioning the widely known 401(k) type of plan, it is well to note that governmental employers such as KPERS may not create a 401(k) plan at this juncture. Some governmental entities (not including Kansas) have "grandfathered" 401(k) plans. Unless a state or local government had established a "cash or deferred arrangment" (a 401(k) plan) prior to May 6, 1986, under federal law they may not establish a new 401(k).

[5] Each year, many terminating KPERS members roll over their KPERS accounts, representing their own accumulated contributions plus interest, into plans sponsored by their new employer, either in the public or the private sector.

[6] For this reason, a KPERS member who becomes eligible for the Regents plan may not transfer their accumulated contributions in the KPERS 401(a) plan to their new account in the Regents 403(b) plan.

[7] It is not true, as some DC proponents imply, that all DC plans vest all participants in an immediate right to 100 percent of the employer money contributed on their behalf. Many plans have graduated vesting, under which an employee might vest in a portion of the employer money after two years, for example, and more each year until there is 100 percent vesting as late as five or seven years after participation commences.

In any event, KPERS statistics show that once a member has stayed in public employment in Kansas for the first five years, the probability of remaining until they reach their ten-year vesting requirement is quite high. For example, for a female in state employment hired at age 25, the probability of vesting, assuming she stays employed for the first five years, is 81 percent. Likewise, a female school employee hired at age 25 who stays on the job for five years has a probability of vesting of 85 percent.

A shorter vesting period and the ability to take out employer money are certainly desirable privileges from the employees' standpoint. But it ignores reality to promote DC plans because they provide more vesting advantages for short-term employees and at the same time assert that everyone will be better off. *For more money to come out, more money has to go in.* It simply cannot be assumed that governmental employees who join a DC plan will all invest so brilliantly in the markets that the disadvantages inherent in the State's low employer contribution levels can thereby be cured. This concern must be confronted in addition to the effect of the DC higher management costs, which are borne by employees. Again, the following equation,

Benefits = Contributions + Investment Earnings – Expenses,

cannot be avoided.

- ### Benefit Adequacy

KPERS benefits, when considered in conjunction with social security, on average exceed a 70 percent replacement ratio of pre-retirement income for a career employee. By virtually any industry standard, this is considered an adequate level of income at retirement. With a DC plan, the adequacy of the income is purely a function of the investment results and contribution rates. If a reasonable average net investment return over the life of the participant is assumed, with the proceeds converted to a life annuity at retirement, the typical DC benefit will be slightly lower than the DB counterpart. Of course, if the DC participant's employer provides a particularly rich match, and / or the timing is such that investment returns were extraordinarily good, the adequacy of the final benefit could be materially improved. By the same token, either poor funding or bad timing in a DC plan could materially reduce the final benefit.

- ### Benefit Payout Options

One of the advantages of a DC plan is the ability to preserve the assets held for retirement to the benefit of heirs, charities or assignees. Presuming adequate alternative resources, or in the event of premature death, DC plans may typically be constructed to allow a participant an ability to direct a lump sum either during retirement or at death. This greater control of assets is attractive.

As with any freedom, however, there are offsetting responsibilities. Numerous industry studies have shown that, provided a lump sum option, many retirees choose to immediately spend some or all of the proceeds. One recent study found that for those allowed control of a lump sum, either during a rollover or at retirement, roughly three of five spent all of the money. This eliminates the ability for these assets to contribute to an adequate benefit during the retirement

years and destroys the ability of the DC plan participant to fulfill the objective of the retirement savings plan.

It appears that any DB plan, including KPERS, could be modified to allow for a partial or total lump sum option, subject to Internal Revenue guidelines. KPERS' actuary has calculated illustrative examples of the way a partial lump sum option would affect a hypothetical member's pension, and those calculations are shown on page 11 of this report.

DB plans also differ from DC in their ability to guarantee a lifetime options. Unless a DC account is converted to an annuity issued through a credit-worthy insurance company, it is impossible for a DC plan to guarantee benefits that cannot be outlived. Continual advances in life expectancy, rising potential medical costs in retirement and erosion of asset values could all cause a DC participant, without alternative means of income support, to outlive or outspend his or her retirement assets.

- **Competitiveness**

Some commentators on the DB/DC debate within Kansas have suggested that a DC plan provides a competitive edge in recruiting and retaining employees. As stated earlier, the most competitive arrangement appears to be a base DB plan with a supplemental DC plan, further supported by an employer match. Through a match, the employer provides an extra deposit, in some predetermined ratio, to whatever amount the employee has deposited. This match is typically in cash, but in the private sector it can be in corporate stock.

Currently, the State of Kansas 457 plan does not contain an employer match. Several other states have considered a match, and some, such as Missouri, have instituted a minimal match. In the Missouri experience, a maximum $25 per employee per month is provided. This match has markedly increased participation. To the extent that the DC plan is supplemental, an increased participation is effectively a win-win outcome, in that the competitiveness of the benefit is enhanced, the terminal benefit is increased and personal savings is encouraged.

- **Death and Disability Benefits**

Death and disability benefits are currently provided and funded within the KPERS plan. The underwriting and delivery of benefits is accomplished through a third-party provider, currently Security Benefit Life Insurance Company. There are no death or disability benefits typically attached to a DC plan, although a similar supplemental arrangement could be made.

- **Ease of Understanding**

While the current value of a DB plan is not well understood during the accumulation phase, it is eminently clear upon retirement. By contrast, while the value of a DC plan is a simple matter of looking up the balance during the accumulation phase, predicting what retirement benefit will result therefrom is not an easy matter.

The current value of a DB plan, as opposed to the ultimate benefit formula, is a difficult concept to communicate and comprehend. For this reason, plan participants seldom appreciate the benefit within the DB plan. With regard to the discussion on competitiveness, this can be a significant drawback in employee relations. Many DB plans have begun placing a greater emphasis on communicating the value of the plan benefit through enhanced and improved reporting.

With a DC plan, the opposite situation exists. The current value of the account is readily apparent, and is typically communicated to the employee on a monthly (if not more often via on-line lookup) basis. The confusion within the DC plan arises when participants attempt to convert the asset balance into a meaningful retirement benefit estimate. To make this conversion, a series of estimates and assumptions must be made, each with its own set of risks. The only true comparative would be to contact a reputable life insurance company and ask them to price a life annuity with the proceeds of the account. This is a fairly difficult task, and one that the average participant will not undertake. Beyond the calculation, the value of the account is moving constantly, making even modest projections (one year prior to retirement, for example) difficult.

- **Pre-retirement Ownership**

Within a DB plan, there is little to no ownership and control of the assets. The participant is typically limited to a withdrawal, subject to the vesting schedule of the plan, of the employee's contributions. Within a DC plan, there are substantial ownership rights prior to retirement. DC plans may have provisions for loans, hardship withdrawals, and lump sums. Philosophically, these alternatives do not fulfill the objective of sustaining retirement benefits. They do, however, provide for the economic sustenance that in some circumstances might be otherwise lacking.

- **Inflation Protection**

DB plans typically provide substantial protection against inflation during the pre-retirement years. This is due to the fact that wages are typically highly correlated with inflation, and the final benefit is usually calculated using the most recent wage information. After retirement, there is no programmed adjustment for inflation within the KPERS plan. In years past, the legislature has, from time to time, declared cost of living adjustments (COLAs) on an ad hoc basis. Last year, there was considerable debate about the costs and ramifications of making the COLA a permanent, formulaic part of the KPERS benefit. This is an option that could be prefunded and priced into the contribution rate, utilizing the same types of actuarial data and estimates as currently used with the balance of the plan, at the option of the Legislature.

DC plans do not provide any overt inflation protection. Depending on the source and nature of the price inflation, investment returns may keep pace or exceed actual price changes.

During periods of high inflation, however, the traditional capital markets that are available within most DC plans (stocks, bonds and cash) do not provide a good hedge against a loss in purchasing power due to inflation.

IV. CONCLUSIONS AND RECOMMENDATIONS

- **In General**

In supporting the best interests of our members, as the Legislature considers various proposals to enhance or change the KPERS DB plan, the Board recommends focusing on the following principles and ideas:

- Acknowledge that DB and DC plans each have attractive attributes and fundamental drawbacks, and that neither provides a superior cost / benefit structure under all circumstances.

- Agree that the most desirable objective is to encourage personal responsibility by public employees, while sustaining a reliable and predictable income-replacement ratio in retirement.

Personal Responsibility and Freedom of Choice.

The famous "three-legged stool" for retirement includes Social Security, a good pension plan like the KPERS DB plan, and personal savings in a voluntary DC plan like the State of Kansas 457 plan. One leg of the stool is weak for Kansas public employees. Therefore, the Board concludes that:

- The current 457 plan is expensive for participants. Many public and private employers have more efficient and less expensive deferred compensation plans and Kansas should, too. [8]

- The current 457 plan contains no low-cost, index alternatives. Adoption of lower cost investment options should be demanded. In addition to creating more competitive management arrangements, the adoption of lower cost investment options should be investigated. Currently, there are no low-cost index alternatives offered within the 457 plan.[9]

- In order to leverage the economies and efficiencies KPERS enjoys in the investment arena, the State should enact legislation to involve KPERS in the 457 plan.[10]

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[8]Participants in the State of Kansas 457 plan must pay between 116 and over 200 basis points (1.16 to over 2 percent) for administration and investment management. To create even a modestly diversified investment portfolio suggests average annual fees approaching an average of one and one-half percent per year. The State depends on Aetna to deliver a "turn-key" program. However, many changes have taken place in the management and administration of qualified plans since Aetna was awarded the original contract in 1980.

[9] It is widely acknowledged that a passive or index alternative is an attraction investment and risk management tool. Passive or index investing is also considerably less expensive than active management. For an employee plan that provides in excess of 30 investment alternatives to not have any indexes to select from does not seem logical.

[10] Many large employers, both public and private, have identified opportunities to leverage the economies and efficiencies currently enjoyed by their DB plans for the benefit of their employees who participate in their DC plan. The State has already created a successful investment and administration infrastructure within the KPERS DB plan

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➢ In any event, the State should provide at least a minimal employer match to encourage employees to demonstrate personal financial responsibility through increased participation in the 457 plan.

- **Wealth Building**

The Board recommends enactment of changes to the KPERS plan that would offer some reasonable options for receiving at least part of the retirement benefit as a lump sum. Consistent with Internal Revenue Code requirements, such design changes could involve:

➢ Taking a reduced monthly benefit in return for an immediate lump-sum payment.

➢ Taking a reduced monthly benefit in return for making a lump sum available to a survivor upon the member's death.

The above options can be afforded to all future retirants on a basis that is cost-free to the System and requires only a stroke of the pen in the legislative process. By authorizing a payment structure that can include reduced monthly benefits in exchange for an immediate or deferred lump-sum payment, the statutes would enable retirement applicants to ponder a type of scenario illustrated by the following examples.*

Age at Retirement	Maximum Monthly Pension	Reduced Monthly Pension (for Lump Sum at Retirement)	Amount of Lump-Sum Distribution at Retirement
62	$2,000	$1,000	$114,048

Age at Retirement	Maximum Monthly Pension	Reduced Monthly Pension (for Deferred Lump Sum upon Retirant's Death)	Amount of Lump-Sum Distribution upon Retirant's Death
62	$2,000	$1,000	$421,000

*The amounts shown are illustrative only and were prepared by the System's actuary based on the current actuarial assumption of 8% interest and the 1994 Group Annuity Mortality Table.

- **Portability and Vesting.**

The Board recognizes that workers in a more mobile workforce are interested in both earlier vesting in a lifetime benefit and vesting in a right to receive some part of employer contributions even if a lifetime benefit is not earned or chosen. Therefore, the Board instructed its actuary to cost out options that include:

- Lowering the KPERS vesting period for receipt of benefits from 10 years to 5 years.
- Lowering the KPERS vesting period for receipt of benefit from 10 years to 7 years.
- Allowing terminating employees to withdraw their own funds with current prescribed statutory interest rates plus some portion of the employer contributions made on their behalf, specifying a graduated vesting schedule for full vesting in employer contributions.

Below are the actuary's projected cost figures for these changes.

State/School Group

	Benefit Enhancement	CHANGE IN CONTRIBUTION RATE			
		UAL Payment	Normal Cost	Total	Change in UAL ($M)
1.	100% vesting after 5 years	0.07%	0.41%	0.48%	26
2.	7 year graded vesting (20% after 3 with 20% for each additional year)	0.06%	0.41%	0.47%	26
3.	Termination benefit of employee balance and employer balance* using 100% vesting after 5 years	0.64%	1.40%	2.04%	342
4.	Termination benefit of employee balance and employer balance* using 7 years graded vesting	0.64%	1.40%	2.04%	342
5.	Termination benefit of employee balance plus employer account balance* times (YOS/30 not greater than 1) using 100% vesting after 5 years	0.31%	0.70%	1.01%	158
6.	Termination benefit of employee balance* plus (YOS/30 not greater than 1) times employer account balance* using 7 year graded vesting	0.31%	0.70%	1.01%	158

*Assumes employer account balance is equal to employee account balance

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Local Group

	Benefit Enhancement	CHANGE IN CONTRIBUTION RATE			
		UAL Payment	Normal Cost	Total	Change in UAL ($M)
1.	100% vesting after 5 years	0.06%	0.39%	0.45%	8
2.	7 year graded vesting (20% after 3 with 20% for each additional year)	0.05%	0.38%	0.43%	7
3.	Termination benefit of employee balance and employer balance* using 100% vesting after 5 years	0.73%	1.69%	2.42%	120
4.	Termination benefit of employee balance and employer balance* using 7 years graded vesting	0.73%	1.69%	2.42%	120
5.	Termination benefit of employee balance plus employer account balance* times (YOS/30 not greater than 1) using 100% vesting after 5 years	0.30%	0.72%	1.02%	50
6.	Termination benefit of employee balance* plus (YOS/30 not greater than 1) times employer account balance* using 7 year graded vesting	0.29%	0.72%	1.01%	50

*Assumes employer account balance is equal to employee account balance

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APPENDIX 1.

TERMS AND DEFINITIONS

A number of terms are being used in Kansas to describe the types of proposals, whether actually in bill-draft form or merely the subject of some discussion in the Legislature, to add DC features to the DB plans now in place, or to convert the plans to mandatory DC arrangements for all new employees going forward. Following are some general definitions for reference.

- **Defined Benefit.** DB plans provide income for retirement based on a formula that is fixed; thus there are "defined benefits." As with other public pension funds around the country, in Kansas the formula is set by statute. The formula is calculated as a percent of a worker's salary, usually earned shortly before retirement, called Final Average Salary or FAS. In Kansas, the FAS is based on either the high twelve or the high sixteen quarters of earnings, depending on the date of the worker's hire. Although some state systems have a percent-of-salary multiplier that slides or increases with the number of years worked, many, like Kansas, have a flat multiplier applied to all years of participating service.

  The KPERS DB formula is: [FAS] x [1.75 percent] x [years of service]. For a worker with 30 years of participating service, this results in an annual pension, guaranteed for life, equal to 52.5 percent of FAS. When Social Security benefits are considered, KPERS career members (those who retire with 30 years of service) have an initial income replacement ratio of more than 70 percent.

  In a DB plan, the employer contribution rate "floats" from year to year. It can go up or down depending on the actuarial requirements, which are based on what is needed to fund the promised benefits under the formula. Good investment performance and responsible funding (which includes paying contributions in a timely manner, at the rate the actuary prescribes) will help the employer keep the rate down. Historically, based on both these factors, KPERS employer rates have been low compared to other public plans. In a DB plan, good investment performance redounds mainly to the benefit of the employer.

- **Defined Contribution.** DC plans provide income based on annuitizing or otherwise distributing the savings accumulated in an individual employee's account over the course of the employee's career. The employee and employer make fixed or "defined contributions" to the plan. Unlike in a DB plan, in a DC plan the employer contribution rate does not "float." Since there is no guarantee of a defined benefit, there is no actuarial necessity for employer contributions to rise or fall. Retiree benefits are not set by a guaranteed formula but depend solely on the total contributions to and investment experience of the individual account. Once the money is in an employee's DC account, typically the employee selects investments in various financial instruments. Usually the employee may choose from a menu of options put together by the plan sponsor (employer), the plan's investment board, or the plan's third-party provider. At retirement, the employee obtains both the employer and employee contributions plus earnings. The level of income is not known until retirement and is not

guaranteed. Depending on the plan, the distribution from the employee's account can be either in the form of a single lump sum distribution or periodic payments.

Under most DC plans, an employee who terminates employment prior to retirement may take all or part of the employer contributions as well as his or her own contributions, and accumulated earnings. How much of the employer's share the employee is entitled to take depends on the plan's vesting schedule.[11] The Board of Regents plan authorized under K.S.A. 74-4925 et seq. is a defined contribution plan governed by section 403(b) of the Internal Revenue Code. In the private sector, the most widely known type of DC plans are governed by section 401(k) of the Internal Revenue Code. (As stated in footnote 4 of this Report, governmental entities may not establish 401(k) plans under current law.) In contrast to a DB plan, in a DC plan good investment performance redounds mainly to the benefit of the employee.

- **Deferred Compensation.** A deferred compensation arrangement postpones payment for currently rendered services until a future date, with the effect of postponing the taxation of the deferred compensation until it is received. In the private sector, many employers use this type of plan to provide benefits in excess of the limitations the Internal Revenue Code places on qualified plans. Thus, deferred compensation plans are referred to (confusingly) as "nonqualified" deferred compensation arrangements. The deferred payments may be paid by the employer as additional compensation for the employee's services, or may be derived from the employee's voluntary agreement to take a reduction in current salary.

  In the public sector, the same postponement of taxation is available for deferring part of an employee's compensation. Section 457 of the Internal Revenue Code contains the special requirements applicable to governmental deferred compensation plans (also called "nonqualified" deferred compensation arrangements). These requirements affect plan participation; timing of deferrals; availability of amounts payable (e.g., at age 70 ½; upon termination from service, or in the event of an "unforeseeable emergency); deferral limits (e.g., in 1999, the lesser of 33 1/3 percent of compensation or $8,000); and distribution requirements. The Aetna-administered deferred compensation plan for State of Kansas employees is a public-sector nonqualified deferred compensation arrangement under section 457 of the Internal Revenue Code. There may be an employer match for a 457 plan. In the State of Kansas plan there currently is not.

- **Tax-Sheltered Annuities.** TSAs are a type of deferred compensation plan governed by section 403(b) of the Internal Revenue Code. By law, 403(b) deferrals are available only to employees of certain non-profits as specified in section 501(c)(3) of the Internal Revenue Code, and employees of public schools. Sometimes a 403(b) plan is the primary pension vehicle, as in the case of the Kansas Board of Regents DC plan. There may or may not be an employer match for savings in these plans. In the Kansas Board of Regents plan, there is an employer match that exceeds the employee deferral (8.5 percent employer contributions vs.

[11] The federal law known as ERISA (Employee Retirement Income Security Act of 1974) requires private-sector plans to vest their participants either on a graduated schedule that reaches full vesting in seven years, or on a "cliff-vesting" schedule that fully vests the employee, all at once, at the end of five years with no vesting in employer money prior to that time. ERISA does not govern public-sector plans.

5.5 percent employee contributions). In K-12 public school districts in Kansas, 403(b) plans are supplemental to the KPERS DB plan.

- **Pension Equity Plan.** A "PEP" plan assigns an accrual rate to each year of service. The assigned accrual rate increases with the employee's age. At the time of retirement, the accrual rates earned each year are added together. The resulting total percentage is applied to FAS and determines the amount of the employee's retirement distribution. (Example: a 25-year employee with FAS of $30,000 has annual accrual percentages which, when totaled, equal 200 percent. This employee is entitled to a lump sum distribution of 200 percent of FAS, or $60,000. Alternatively, this lump sum may be annuitized and the employee may receive it in a series of periodic payments.) Often, a PEP would provide a career employee with a total pension value significantly inferior to the actuarial value of guaranteed lifetime monthly benefit under a typical DB plan. But, depending on the accrual rates and vesting schedule, such a plan could be attractive to short-term, younger, more mobile employees.

- **Cash Balance Plan.** Cash Balance plans are a variation on the traditional DB plan, with a DC "take it with you" or "portability" component. A cash balance plan calculates benefits in a manner similar to a DC plan. Under a Cash Balance plan, benefits are accrued at a steady pace throughout a worker's years of employment. Younger workers who leave their jobs after a short time will benefit more from a Cash Balance plan, because the accrued benefits they cash in and take with them are larger. Older workers lose with an all-out conversion to this type of plan, because the portion of their pension accrued in their final years is smaller than it would have been under a traditional DB plan, and thus their overall pension is smaller. These plans have been much in the news lately. Many large corporate plans have switched or are planning to switch their traditional DB pension plans to this new structure because they are far less expensive. Older workers whose traditional DB benefits are threatened, and those younger workers who anticipated spending an entire career with the same company, are concerned and have raised objections, some of which have made it into the media.

- **Hybrid Plan.** Some governmental pension plans have responded to the pressure for conversion to DC by adding DC components to their DB plans – for example, by creating "two plans" with the same amount of funding. In the State of Washington, the employee contribution now goes to a DC plan, with the employee directing his or her investments in a range of mutual funds, while the employer contribution continues to fund a (reduced) DB plan.

- **DROP Plan.** "Deferred Retirement Option Plans" or DROPs are an enhancement to a traditional DB plan. A retirement-eligible employee promises to retire on a date certain in the future. The employee's benefit entitlement is calculated immediately and is paid to an escrow account on the employee's behalf each month, from the date the employee enters the DROP until the date the employee leaves employment. During the interim, usually limited by the plan's terms, the accumulated deposits to the DROP account are credited with an agreed form of earnings or interest. The employee receives no further service credit or salary credit in the DB plan. On the stated date, the employee retires on the monthly benefit as calculated when he or she entered the DROP, and the accumulated amount in the DROP account is distributed as either a lump sum or an annuity.

APPENDIX 2.

LEGISLATIVE HISTORY / KPERS COVERAGE

KPERS came into existence on January 1, 1962, the effective date of the Kansas Public Employees Retirement System Act, codified at K.S.A. 74-4901 *et seq.* As part of this legislation the State, including all its agencies and divisions, immediately became one participating employer in KPERS. Local units of government and instrumentalities thereof are allowed to affiliate with KPERS if their governing bodies so elect. Qualified governmental employers may come into the System on January 1 of the year following receipt of their application. Only employers covered by social security may affiliate. Each year additional employers join KPERS after a governmental-status review by staff and approval by the Board. The choice to become a participating employer is irrevocable. Legislation effective in January 1971 caused school employees to become KPERS members, as school districts were mandated to affiliate with KPERS, and KPERS was required to take over the liabilities of (and benefits administration for) the former Kansas School Retirement System.

To be covered by the KPERS plan, employees of participating state and local employers must be in a permanent position that requires at least 1,000 hours of paid work per year. Non-school employees must work for one year before becoming eligible for membership. School employees are eligible for KPERS membership immediately if their position requires at least 630 hours per year or 3.5 hours per day for at least 180 days. An employee whose position meets eligibility criteria must, by law, be enrolled in KPERS membership.

There is an exception to the universal-participation requirement for elected officials, who have a one-time irrevocable election whether or not to join. Also, certain "state officials," as specified by statute, are allowed to choose participation in the special "eight percent deferred compensation plan" described in Appendix 5.

With special provisions described in Appendix 5, Board of Regents faculty and unclassified employees have been included in certain KPERS benefits from the System's inception, though they have a separate 403(b) Defined Contribution plan for retirement benefits. (The Regents DC plan is often referred to, in bureaucratic shorthand, as "TIAA," and Regents plan members who receive KPERS benefits are often called "TIAA members.")

Finally, correctional employees covered by KPERS are subject to separate provisions allowing retirement at an earlier age than regular members.

APPENDIX 3.

KPERS BENEFITS

- **Basic Retirement.** Members may retire with unreduced benefits at age 65 with as little as one year of service, at age 62 with ten years, or at any age when years of age and service added together equal 85. Early retirement with a reduced benefit is available at age 55 with ten years of service. Retirement benefits are based on a statutory formula, currently 1.75 percent of final average salary (FAS) times years of service.

- **Survivor Options.** At retirement, a member may choose a Joint and Survivor option, reducing the monthly retirement benefit in order to fund an ongoing survivor benefit after the member's death. This is usually, but not necessarily, done to provide for the member's surviving spouse. The member may name any person to receive the survivor benefit, or may choose a maximum benefit with no survivor option. If married at the time of retirement, the member must obtain the spouse's written consent to select any form of retirement distribution that would provide a surviving spouse with less than the minimum Joint and Survivor option upon the member's death.

  Available Joint and Survivor options are: Joint and Same (upon retirant's death, survivor continues to receive the same benefit the retirant had been receiving), Joint and Three-Quarters, and Joint and One-Half. Also available are three "Life Certain" options of 5, 10, and 15 years. A Life Certain Option provides that if the retirant dies within the stated life-certain period the retirant's full benefit continues to be paid to the named beneficiary for the balance of the stated period and then ceases.

- **Basic Group Life Insurance.** All active KPERS members as well as Regents plan members (and some employees in their year of service before membership, if their employer elected first-day coverage for death and disability benefits) are covered by basic group-term life insurance equal to 150 percent of their current annual salary. The employer pays for this coverage by means of an additional contribution to KPERS over and above the regular employer contribution rate. KPERS uses these employer funds to contract with a Third Party Administrator (TPA) to underwrite and administer the group life coverage. Upon retiring or terminating employment, members may convert this basic coverage (and/or their optional coverage, described below) to individual coverage with the TPA, under the terms of the contract between KPERS and the TPA.

- **Optional Group Life Insurance.** At their own expense, through payroll deductions, eligible employees may purchase additional group term life insurance coverage during biennial open enrollment periods, in incremental amounts up to a maximum of $200,000 in face value.

- **Long-term Disability Benefits.** All active KPERS members as well as Regents plan members (and employees in their period of waiting who have first-day coverage) are

protected by a long-term disability program. After an absence from work of 180 days on account of a disability, or when no longer eligible for salary, whichever occurs later, a covered employee who is totally disabled from all occupations may receive a monthly disability benefit equal to two-thirds of salary. Disabilitants receive service credit in the retirement system while in receipt of this benefit, and they retain their group term life insurance under a waiver-of-premiums provision in the insurance contract. If their disability persists for five years or more leading up to retirement, their final average salary upon retirement will be increased by a statutory indexing factor. The long-term disability benefit is also funded by the employer, by means of the additional contribution rate mentioned under "Basic Life Insurance," above. The KPERS disability benefit is subject to offset by the amount of any social security and workers compensation the member receives – the goal being for all benefits, initially, to total 66 2/3 percent of salary. Subsequent increases in social security do not further reduce the KPERS benefit. KPERS underwrites the long-term disability coverage, and the TPA administers the program.

To fund both the basic group term life insurance and the long-term disability coverage, participating employers pay an additional 0.6 percent of covered payroll over and above their retirement contributions. The statute requires KPERS to use this amount of funding to purchase the best available life and disability coverage that can be obtained for this price, with provisions that are standard in the industry for such policies.

- **Service-connected Death Benefits.** The spouse of a member who dies on the job from work-related causes receives a lump-sum payment of $50,000, the return of the member's accumulated retirement contributions account, and a monthly benefit based on 50 percent of the member's final average salary. This benefit is a function of the retirement system. That is, along with other retirement benefits, this benefit is funded from the regular employer and employee contribution rates.

- **Retirant Death Benefit.** The beneficiary of a retirant who dies is entitled to receive the $4,000 retirant death benefit. This is also a plan benefit, funded by the regular employer and employee contributions.

- **Withdrawal of Contributions.** When KPERS members leave employment with a participating employer they are free to withdraw their KPERS contributions plus accumulated interest (after a waiting period of 30 days).

- **Supplemental 457 Plan for State Employees.** The Department of Administration contracts with a mutual plan provider and plan administrator, Aetna Financial Services, for a supplemental 457 plan that is available to all State employees.[12] This is not a KPERS benefit nor is it administered in any respect by the KPERS Board or staff. It isn't authorized under the Retirement System Act but under the Payroll Accounting for State Agencies Act, at K.S.A. 75-5521.[13]

  Under the State's 457 plan, employees may save up to the lesser of $8,000 or 33 1/3 percent of salary per year on a tax-deferred basis. Employees direct their own investments by selecting from a range of mutual funds chosen and made available by Aetna. The employees bear the investment risk (and reward), pay the management fees, and accumulate investment returns on a tax-deferred basis. Unlike 403(b), 401(k), or 401(a) accounts, 457 accounts may not be rolled over to an IRA or other employee plan, except to another 457 plan. The State provides no matching contributions for participants in this plan.

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[12] Local units of government are authorized to elect participation in this plan for their employees. KPERS does not have figures on how many local units have chosen to do so, but we understand generally that it is a small number. The reasons for this are not clear.

[13] In contrast to the arrangement in Kansas, a number of public sector pension plans in other states have a 457 plan automatically available to all members as a supplement to the DB plan, and in many of those cases the pension board and staff of the DB plan either administer the 457 plan or manage the contractual arrangement with the third-party administrator.

APPENDIX 4.

CONTRIBUTION RATES FY 2000

To the KPERS DB Plan. Current contribution rates for employers and employees covered by KPERS benefits are listed below, according to type of membership in the plan. The employer rate "floats" from year to year, up or down, depending upon the actuarial needs of the plan.

	State/School	Local	Regents
• **Employee**	4.00%	4.00%	None to KPERS*
• **Employer**	4.19%	2.93%**	1.22%***

*Employees contribute 5.5% to the Regents DC plan.
**Calendar Year 1999.
***This is the contribution rate to amortize the original grant of KPERS "prior service" discussed in Appendix 5.

To the Regents DC Plan. Employer as well as employee contribution rates to the Regents DC plan are fixed. The employer rate does not float with the actuarial needs of the plan. There are no changing actuarial needs as such. Since benefits are not guaranteed, the level of employer responsibility therefor does not move up or down based on actuarial information.

• **Employee**	5.5%
• **Employer**	8.5%***

****This is in addition to the 1.22% contributed to KPERS for prior service liability for those members who never participated in KPERS but were granted credit under the original enabling legislation. This is in addition to the 0.6% contributed to KPERS for the basic group life and long-term disability coverage for Regents plan members. *See* discussion in Appendix 5.

APPENDIX 5.

SPECIAL GROUPS

- **Regents Defined Contribution Plan.** As part of the original KPERS enabling legislation, authority was also given to the State Board of Regents to enter into contracts to assist in the purchase retirement annuities for faculty and certain unclassified employees at Regents institutions. That is, a DC plan was created, from the original effective date of the KPERS legislation, for certain Regents institution employees.[14] These employees' retirement annuities are based on the total amount of money accumulated in their personal DC account. This total consists of the amount of employee contributions during their career, the amount of employer contributions on their behalf, and the investment earnings thereon.[15] No pension "formula" based on salary and service credit and a multiplying factor is involved. The Regents DC plan is governed by section 403(b) of the Internal Revenue Code.[16]

  As with employees under the regular KPERS plan, employees covered by the Regents DC plan received KPERS "prior service" at the time of the original 1961 legislation. "Prior service" is a statutory term applicable only to an employee's service with an employer before it affiliated with KPERS. Thus, certain Regents employees who have never participated in or contributed any money to KPERS, at retirement receive a benefit from KPERS based on their Regents-institution prior service. This legislative provision created for the Regents institutions a specific liability to KPERS, which has been amortized over the years and is nearly retired.[17]

- **Eight-Percent Deferred Compensation Plan.**

➢ **For State Officers.** In 1988, legislation was enacted to allow the governor's cabinet secretaries, certain State board and commission members, and specified legislative staff to elect not to participate in KPERS. Instead, they may choose to participate in a special State-sponsored deferred compensation program, whereby the State contributes eight percent of the employee's compensation to the plan. Total contributions on behalf of the employee cannot

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[14] 1975 legislation provided coverage under this plan to all unclassified employees of Regents institutions, mandating that, as of July 1, 1976, such employees had an election to stay under KPERS or participate in the Regents DC plan. Those electing the Regents plan had their accumulated contributions plus a matching amount of employer contributions transferred to the Regents plan administrator. All unclassified Regents institution employees hired after July 1, 1976 are automatically under the Regents DC plan.

[15] Both the employer and employee retirement contribution rates for Regents plan participants are higher than the corresponding rates for KPERS participants, as shown in Appendix 4, setting forth contribution rates for FY 2000.

[16] The KPERS DB plan is governed by section 401(a) of the Internal Revenue Code.

[17] Eventually, the "prior service" provision for eligible Regents plan participants was changed so that the employee's FAS, for purposes of their pre-1962 Regents prior-service benefit from KPERS, is calculated by using their post-1961 highest years of salary as a Regents-institution employee. Thus, at retirement, certain Regents employees who never participated in KPERS receive from KPERS a benefit equal to 1.00% times current Regents final average salary, times their years of pre-1962 service. This special advantage for certain Regents faculty and unclassified employees creates substantial additional costs, which have contributed to KPERS' unfunded actuarial liability.

exceed the annual limits imposed by section 457 of the IRC, currently the lesser of $8,000 or 33 1/3 percent of compensation.

- **For Session-Only Employees of the Legislature.** In 1996, a pay-as-you-go pension plan for employees of the Legislature who work only during the session was closed. New employees and those current employees at the time who elected to transfer were placed under the above special eight-percent deferred compensation plan.

The latest figures indicate there are 83 participants in the above state-officer and session-only-employee groups combined, for whom the State contributed $194,456 in calendar year 1998.

APPENDIX 6.

KPERS DEMOGRAPHICS*

	State/School	Local
• **Active Members**		
➢ Number	100,455	31,414
➢ Average age	44.14	44.21
➢ Average service	10.64	9.21
➢ Average salary	$28,078	$27,542
• **Inactive**		
➢ Number	19,976	4,897
• **Retired**		
➢ Number	38,003	9,824
➢ Average benefit	$8,542	$5,803
➢ Average age	73.80	73.60

*As of July 1, 1999

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEMS

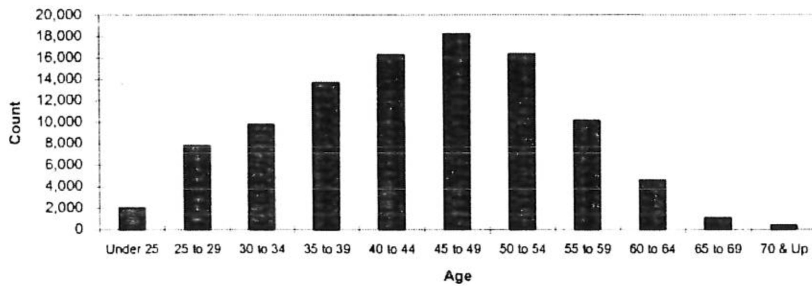
DISTRIBUTION OF ACTIVE MEMBERS

as of July 1, 1999

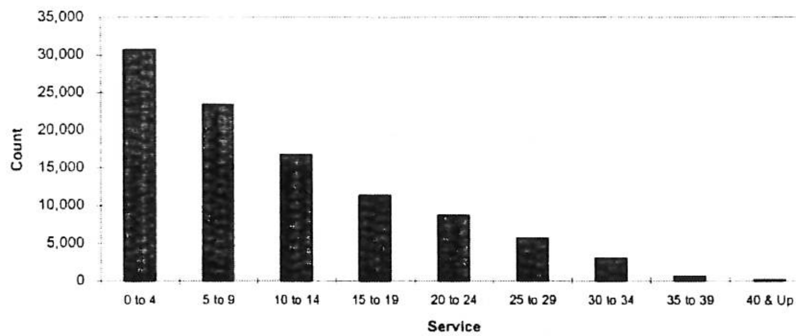
STATE/SCHOOL

	Service									
Age	0 to 4	5 to 9	10 to 14	15 to 19	20 to 24	25 to 29	30 to 34	35 to 39	40 & Up	Total
Under 25	2,000	21	0	0	0	0	0	0	0	2,021
25 to 29	6,288	1,522	12	0	0	0	0	0	0	7,822
30 to 34	4,390	4,158	1,210	28	0	0	0	0	0	9,786
35 to 39	5,203	3,479	3,526	1,412	59	0	0	0	0	13,679
40 to 44	4,668	4,183	2,867	2,941	1,573	41	0	0	0	16,273
45 to 49	3,654	4,188	3,471	2,322	3,001	1,552	34	0	0	18,222
50 to 54	2,283	3,005	2,936	2,303	2,007	2,444	1,359	14	0	16,351
55 to 59	1,278	1,564	1,695	1,530	1,345	1,130	1,261	348	23	10,174
60 to 64	627	888	780	656	589	425	277	265	79	4,586
65 to 69	221	301	184	119	94	76	39	27	45	1,106
70 & Up	101	125	83	43	32	21	14	6	10	435
Total	30,713	23,434	16,764	11,354	8,700	5,689	2,984	660	157	100,455

Age Distribution



Service Distribution

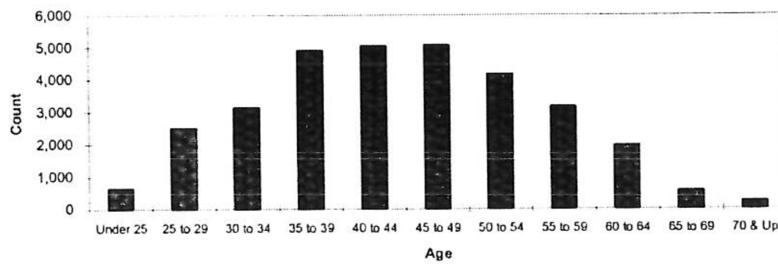


KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DISTRIBUTION OF ACTIVE MEMBERS
as of July 1, 1999

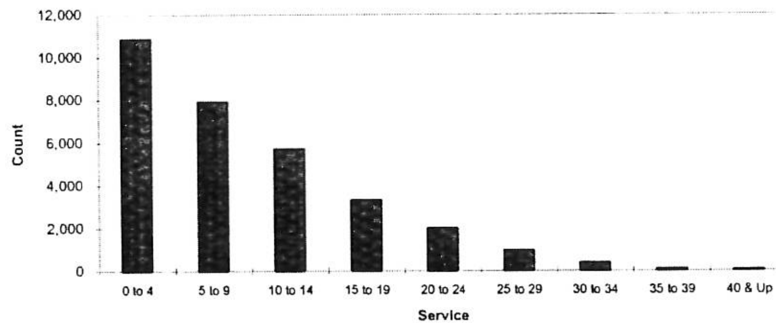
LOCAL

	Service									
Age	0 to 4	5 to 9	10 to 14	15 to 19	20 to 24	25 to 29	30 to 34	35 to 39	40 & Up	Total
Under 25	643	11	0	0	0	0	0	0	0	654
25 to 29	2,034	469	8	0	0	0	0	0	0	2,511
30 to 34	1,614	1,158	359	8	0	0	0	0	0	3,139
35 to 39	1,900	1,419	1,089	461	35	0	0	0	0	4,904
40 to 44	1,463	1,363	1,077	733	386	24	0	0	0	5,046
45 to 49	1,229	1,279	1,059	680	551	253	19	0	0	5,070
50 to 54	912	956	889	544	423	311	120	5	0	4,160
55 to 59	596	685	661	491	336	213	133	47	4	3,166
60 to 64	328	384	416	315	219	130	88	48	34	1,962
65 to 69	95	152	119	68	50	33	21	5	12	555
70 & Up	51	58	47	35	23	13	8	4	8	247
Total	10,865	7,934	5,724	3,335	2,023	977	389	109	58	31,414

Age Distribution



Service Distribution



APPENDIX 7.

KPERS COMPARED TO OTHER STATE DB PLANS*

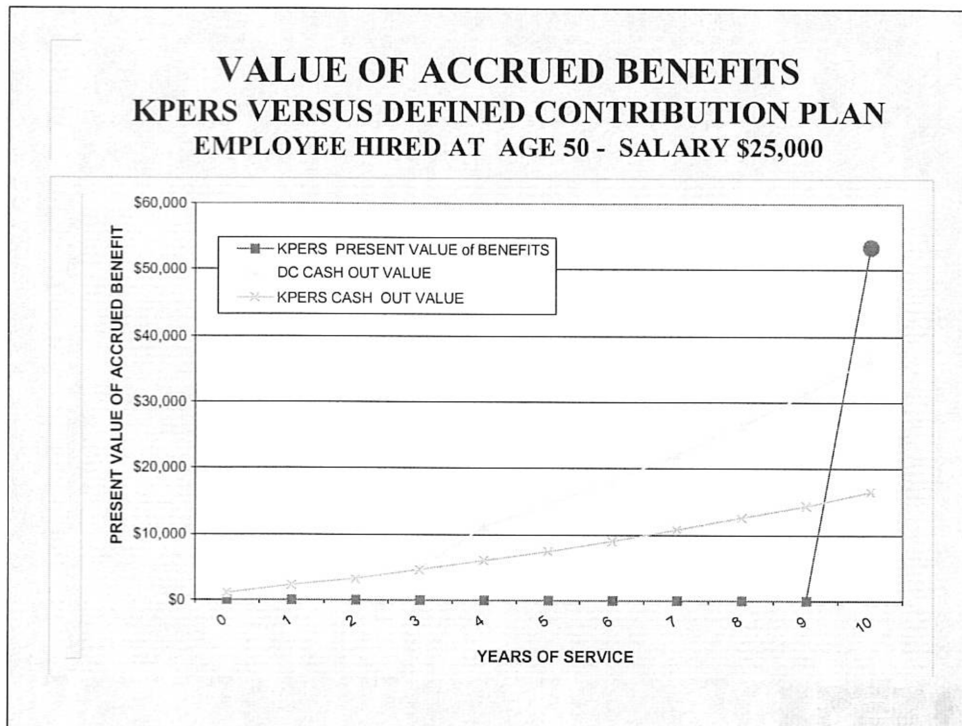
STATE SYSTEM	DB Formula	Employee Rate (percent of salary)	FY 1999 Employer Rate (percent of salary)	Funded Ratio: $ on hand v. $ nec. for full funding (percent)	COLAs for Retirees	Social Security Coverage
Alabama TRS	2.0125 x FAS x yrs	5.00	**9.66**	88.80	ad hoc	yes
Alabama ERS	2.0125 x FAS x yrs	5.00	**7.56**	93.60	ad hoc	yes
Arkansas PERS	1.70 x FAS x yrs	0.00 (or 6.00 if contributory election)	**10.00 state 4.00 school**	110.00	CPI up to 3%, compounded annually	yes
Colorado PERA	2.50 x FAS x yrs (limit 100% FAS)	8.00	**11.40**	91.60	CPI up to 3.5%, compounded annually	no
Iowa PERS	2.00 x FAS x yrs (up to 30), 1.00 for yrs 31-35 (limit 65% FAS)	3.70	**5.75**	93.86	80% of CPI up to 3%	yes
KPERS State/sch. local	1.75 x FAS x yrs same	4.00 same	**3.99** **2.78 (CY 1998)**	83.00	ad hoc	yes
Louisiana PERS	2.50 x FAS x yrs (limit 100% FAS)	7.50	**13.00**	65.80	ad hoc	no
Missouri SERS	1.60 x FAS x yrs	0.00	**12.58**	79.90	80% of CPI up to 5%	yes
Oklahoma TRS	2.00 x FAS x yrs	7.00	**12.80**	42.90	ad hoc	yes
Oklahoma PERS	2.00 x FAS x yrs	3.50	**12.50**	91.00	ad hoc	yes
Texas TRS	2.00 x FAS x yrs	6.40	**6.00**	99.70	ad hoc	no
Texas ERS	2.25 x FAS x yrs (limit 100% FAS)	6.00	**6.00**	103.20	ad hoc	yes

*Material compiled from *Characteristics of 100 Large Public Pension Plans*, National Education Association, Research Division, September 1998

APPENDIX 8.

SOFTWARE TO ASSIST PLAN DESIGN DISCUSSIONS

KPERS is working with Milliman & Robertson to develop interactive software that will allow decision-makers to model various retirement scenarios for different types of employees. The charts below compare DB and DC plans on a present-value basis for several types of employees.



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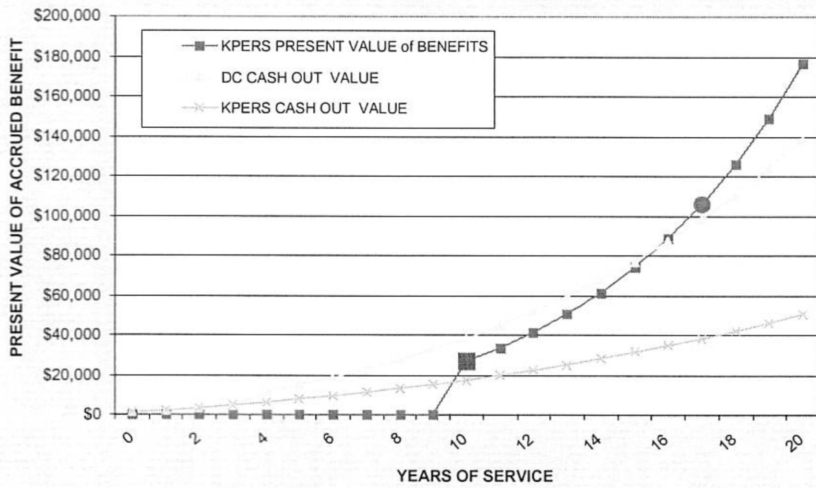
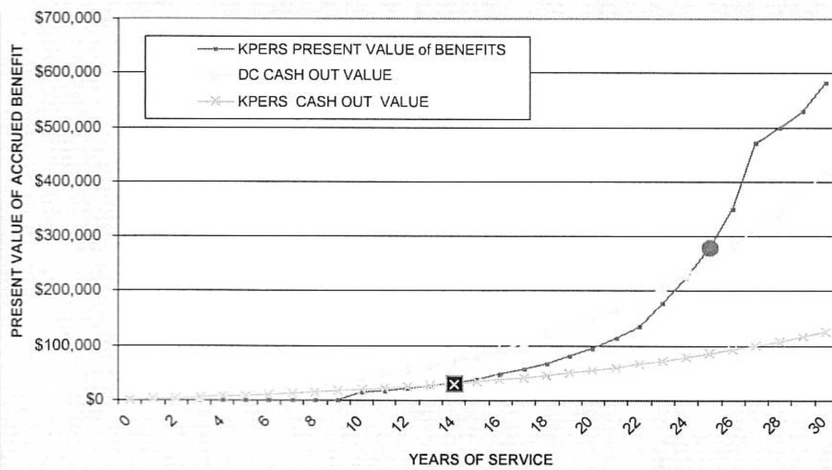
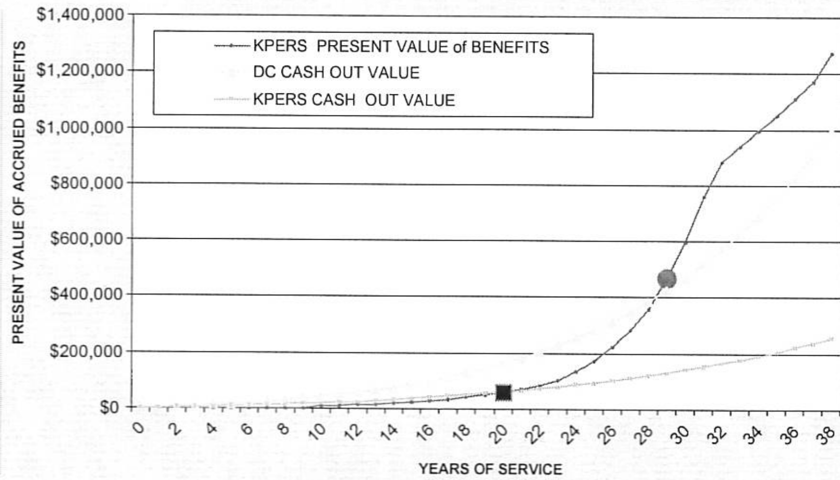

VALUE OF ACCRUED BENEFITS
KPERS VERSUS DEFINED CONTRIBUTION PLAN
EMPLOYEE HIRED AT AGE 40 - SALARY $25,000
KPERS PRESENT VALUE of BENEFITS
DC CASH OUT VALUE
KPERS CASH OUT VALUE
PRESENT VALUE OF ACCRUED BENEFIT
$200,000
$180,000
$160,000
$140,000
$120,000
$100,000
$80,000
$60,000
$40,000
$20,000
$0
0
2
4
6
8
10
12
14
16
18
20
YEARS OF SERVICE


VALUE OF ACCRUED BENEFITS
KPERS VERSUS DEFINED CONTRIBUTION PLAN
EMPLOYEE HIRED AT AGE 30 - SALARY $25,000
KPERS PRESENT VALUE of BENEFITS
DC CASH OUT VALUE
KPERS CASH OUT VALUE
PRESENT VALUE OF ACCRUED BENEFIT
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
0
2
4
6
8
10
12
14
16
18
20
22
24
26
28
30
YEARS OF SERVICE



1-36

PLAN DESIGN:
A Review of Current Public Pension Issues

Presented by the
Kansas Public Employees Retirement System

January 26, 2000

Kansas 2000 Select Committee
Meeting Date 1-26-00
Attachment 2

Plan Design
Defined Benefit/Defined Contribution

Kansas Public Employees Retirement System
January 26, 2000

Bottom Line

	Contributions
+	Investment Earnings
-	Expenses
=	Benefits

2-2

Why Do We Have Pension Plans?

- Employees save for the future
- Employers attract and retain employees
- Society benefits, too

Are All Pension Plans Alike?

- Defined benefit plans -- "Traditional pensions"
- Defined contribution plans -- "What you save is what you get"

Defined Benefit Plans "Employee Perspective"

Advantages
- No investment risk
- COLAs are possible
- Favors long-term employees

Disadvantages
- No investment advantage
- COLAs are not always granted
- Short-term employees fare less well

Defined Benefit Plans "Employer Perspective"

Advantages
- Cheaper
- Employer wins when markets go up
- Employer can create benefits

Disadvantages
- Funding not totally predictable
- Employer loses when markets go down
- Employer can create benefits

Defined Contribution Plans "Employee Perspective"

Advantages
- Controls investments
- Gains with good investments
- Portable
- Understandable

Disadvantages
- Investment expertise needed
- Loses with bad investments
- Rollovers
- Inequalities

Defined Contribution Plans "Employer Perspective"

Advantages
- Administration
- Investment risk on employee
- No unfunded liability
- No benefit changes or COLAs

Disadvantages
- Administration
- Education requirement
- Costs higher
- No benefit changes or COLAs

Conventional Wisdom and Conceptual Misunderstandings

- DC plans are less expensive
  - Investment management
  - Benefit/Account administration

Conventional Wisdom and Conceptual Misunderstandings

- DC plans create greater wealth for the participant
  - Average investment return for DC plans equal to return for DB plans
  - DC plans have higher expenses

KPERS

2-6

Conventional Wisdom and Conceptual Misunderstandings

- Converting to a DC plan will eliminate or improve the unfunded liability
  - DC plan will not create unfunded liability
  - DC plan will not eliminate existing unfunded liability

Conventional Wisdom and Conceptual Misunderstandings

- Most attractive alternative for employers is always a DC plan
  - DC and DB plans are complimentary
  - DC plan participants share in return and customize investments
  - DB plans provide guaranteed lifetime benefits

Major Defined Benefit / Defined Contribution Issues

- Individual freedom and elimination of government
  - DC plan participants may make poor investment choices
  - Government involvement will not go away with a DC plan
  - DC plans provide freedom of choice for participants

Major Defined Benefit / Defined Contribution Issues

- Portability
  - Vesting (determined by plan design)
    - Immediate
    - Deferred
  - Transferability
    - Allowed in both DC and DB plans
    - Governed by Internal Revenue code

Major Defined Benefit / Defined Contribution Issues

- Likelihood of vesting
  - Longer vesting periods keep plan costs down
  - Shorter vesting period has a cost

Major Defined Benefit / Defined Contribution Issues

- Benefit Adequacy
  - With DC plan, retirement income depends on individual investment results and contribution rates
  - With DB plan, retirement income depends on the benefit formula

Major Defined Benefit / Defined Contribution Issues

- Benefit payout options
  - Lump sum payments
    - Typically provided by DC plans
    - May be provided by DB plans
  - Guaranteed Lifetime Options
    - Generally not provided by DC plans
    - Provided by DB plans

Major Defined Benefit / Defined Contribution Issues

- Competitiveness
  - DB plan with supplemental
  - DC option with employer match

Major Defined Benefit / Defined Contribution Issues

- Death and disability benefits
  - Provided by KPERS DB plan
  - Not usually provided by DC plans

Major Defined Benefit / Defined Contribution Issues

- Ease of understanding
  - Present value of DC plan easily understood
  - Present value of DB plan not well understood
  - Expected retirement benefit in DC plan difficult to predict
  - Expected retirement benefit in DB plan readily predictable

Major Defined Benefit / Defined Contribution Issues

- Pre-retirement control of assets
  - Substantial control with DC plan
  - Little control with DB plan

Major Defined Benefit / Defined Contribution Issues

- Inflation protection
  - DC plans may not provide inflation protection
  - DB plans provide some protection against inflation
    - Pre-retirement
    - Post-retirement

Conclusions and Recommendations

Contributions
+ Investment Earnings
- Expenses

= Benefits

Conclusions and Recommendations

- In general
  - DB and DC plans both have attributes and limitations
  - Plan objective should be to encourage personal responsibility while providing adequate retirement benefits

Conclusions and Recommendations

- Personal responsibility and freedom of choice
  - Lower cost structure of 457 plan
  - Expand investment options to include passive choices
  - Consider KPERS participation in 457 plan management
  - Initiate employer match

Conclusions and Recommendations

- Wealth building
  - Lump-sum options
    - Immediate
    - At retirement
    - At death

Conclusions and Recommendations

- Portablility and vesting
  - Consider reducing KPERS vesting schedule
    - From 10 to 5 years
    - From 10 to 7 years
  - Enhanced withdrawal rights