Approved: March 15, 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 February 3, 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
Julian Efird, Legislative Research Department
Gordon Self, Revisor of Statutes
Janet Mosser, Committee Secretary

Conferees appearing before the committee:
Representative Tim Carmody

Others attending: See attached list.

Chairperson Wilk recognized Representative Gene O'Brien who welcomed students from Parsons High School video production class to the meeting. Unless the committee objects, the students will film today's meeting. There were no objections.

Chairperson Wilk continued the hearing on **HB 2718 - Defined contribution plan for state employees**.

Representative Tim Carmody, sponsor and proponent, continued his testimony from the previous meeting beginning with Question 7 (Attachment 1). Discussion and questions followed. Issues identified for consideration for the next draft of the bill were: the entire employer contribution should go to the employee who can put it in the defined contribution plan; put a "floor" on the withdrawal guaranteeing the employee their contribution plus some percentage; give KPERS authority to do calculations and contact each employee; the effect of the bill on legislators retirement plans and the bill sponsored by Representative Jenkins; decide on the percent the employee must contribute; consider graduated vesting to encourage continued employment with the state; decide on the "floor" percent the employer must contribute below which the employer cannot go; possible need for subsequent tax bill on how the new plan will be taxed; improve KPERS by giving the employee a lump sum option; and the options to defuse fear about converting to a defined contribution plan and the stability of the defined benefit plan (e.g., extend the window of time the employee has to decide to change to the defined contribution plan, provide dollar comparisons on what the plans provide, determine a date on which all current employees in the defined benefit plan stay in the defined benefit plan and after this date all new employees, and current employees who choose to do so, convert to a defined contribution plan).

Questions and discussion followed testimony.

Chairperson Wilk expressed his appreciation to Representative Carmody for the information he prepared and shared with the committee. The extent and detail of the information presented indicate the complexity and importance of the issue.

Chairperson Wilk closed the hearing on **HB 2718**.

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

The next meeting is scheduled for February 8, 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: 2-3-00

NAME	TITLE	REPRESENTING
Keith Haxton	Lobbyist	SEAK
Marton Hauver		Hauver's ~~National~~ Capitol Report
Jack Hann		KPERS
Meredith Williams		"
Rob Woodard		"
Bill Henry		Valic
Bob Corkins		Ks Public Policy Institute
Jerry Sloan		Judicial

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COMMITTEE ASSIGNMENTS
CHAIR—RULES AND JOURNAL
VICE-CHAIR—JOINT COMMITTEE ON PENSION BENEFITS AND INVESTMENTS
VICE-CHAIR—JUDICIARY
MEMBER—KANSAS 2000

TOPEKA

HOUSE OF REPRESENTATIVES

February 2, 2000

Testimony on H.B. 2718

A. What are the concepts behind defined contribution and defined benefit retirement plans?

In a defined benefit plan the retirement benefit is based on a formula similar to the one currently in use in KPERS: Years of covered employment x 1.75% x final average salary = retirement benefit. In a defined contribution plan, the retirement benefit is a fund which has accumulated during the course of employment.

B. What are the primary features of the two plans?

The features of a defined benefit plan are as follows:

a. The benefit is known and "guaranteed" by the employer.
b. The benefit is paid for the life of the retiree (or that life and one other) after his or her retirement and cannot "run out".
c. The employee cannot access the funds unless the employee leaves employment prior to retirement.
d. The return on investment accrues to the benefit (or detriment) of the plan, not to individual employees or retirees.

The features of a defined contribution plan are:

a. The retirement benefit is unknown until retirement.
b. Employer contributions become the employees property.
c. Return on investment accrues to the benefit (or detriment) of the individual employee/retiree.
d. Employee can roll out the account balance, which includes both the employer and employee contributions, into another tax qualified plan if employment is terminated.

C. Further questions and answers.

1. Vesting: What is vesting? What is the current law? What if an employee is not vested? What would H.B. 2718 do?

Kansas 2000 Select Committee
Meeting Date 2-3-00
Attachment 1

"Vesting" is the right to receive a certain benefit. Generally, under current law, a state/local/school employee must pay into the system for a minimum of ten years in order to acquire the right to a retirement benefit. That retirement benefit is based on the formula referred to above. If an employee is not vested and leaves covered employment, either voluntarily or not, they can withdraw their contributions with 4% interest. The employer contributions are kept within the fund.

There is no minimum period of employment required in order to receive benefits under the plan proposed in H.B. 2718. Upon termination of employment the balance in the account can be withdrawn and that balance includes all employer and employee contributions as well as accumulated income and capital gain (or loss) attributable to the account.

2. How are gains and losses treated in the two plans?

- In a defined benefit plan gains accrue to the benefit of the fund, not directly to the individual employees and retirees although gains act to mitigate the employer contribution rate and reduce the unfunded liability. Losses are not attributable to the employees directly but in order to compensate the fund for any losses, the employer may have to increase the employer and/or the employee contribution rate or obtain a better than anticipated return on investment.

- In a defined contribution plan, the gains and losses are attributable to each account. The employer has no legal obligation to increase the contribution rate if a given employee's account incurs losses or preforms at less than an anticipated rate of return.

3. What does the term "unfunded actuarial liability" mean, in simple terms?

- In simple terms, in a defined benefit plan, certain assumptions are made about the future based on presently available information. Some of the factors which are considered include: The number of current and future employees, the amount of payroll over the next two to four decades, the length of time the average employee will pay into the system, the rate of return on investment, the employer and employee contribution rates, any cost of living increases and the rate of inflation.

  By converting all of these variables into assumptions, one can calculate the anticipated income and expenses of the system over a given period of time, for example, 40 years. If, over that period of time, the anticipated income from investments and employer and employee contribution rates will be less than the costs (administration, benefits paid, etc.) then the resulting figure is a "short fall" or unfunded liability, of the plan. These actuarial assumptions may be reviewed on a one year, three year or longer bases.

It is possible to be "over funded", that is, anticipated income may exceed anticipated costs. This is currently the situation in the death and disability portion of the KPERS system.

A defined contribution plan cannot be over or under funded. Each employee's account is credited with the employer and employee contributions and the return on that account's investments along with deductions for costs of administration, withdrawals and losses on the investments in the account is the retirement benefit. "What you see is what you get", both at retirement and during the course of the employment.

4. What is the effect of H.B. 2718 on the unfunded liability of the current retirement system?

The current KPERS system can break down its liability into individualized segments. Therefore, any employee staying in the defined benefit plan after the election date can be attributed a figure, based on their age, years of covered employment, assumed rate of return and assumed salary progression and their portion of the fund's rate of return which is either a liability or an asset on an individualized basis.

Usually, but not always, an employee who has paid into a defined benefit plan for many years and is nearing retirement has a larger liability than a newer employee. Therefore, if the employees with the relatively higher liability remain in the system and the younger ones leave the system, the unit cost of those remaining will probably rise but the total cost in liability, when expressed as a total dollar amount, may decline.

The unfunded liability could rise both in unit cost and in absolute terms for several reasons:

- No new members joining, therefore no new employer and employee contributions into the system.
- No more new "inactive" members (that is, not currently employed, but their money remains on deposit with the system).
- A less than anticipated rate of return
- Enhancement of benefit package for retirees
- Smaller investment base, that is, funds under administration.
- Losses on investments.

However, with the exceptions of the first, second and fifth reasons, all of these are currently factors anyway. The unfunded liability could also decline for several reasons:

- Larger than anticipated number of "high unit cost" employees switch to the new plan.
- Inactive members could be frozen in place in the defined benefit plan and not allowed to make withdrawals.

- A greater than anticipated rate of return for the fund.

5. If there is an unfunded liability, when must that obligation be met, that is, paid for?

The amount of unfunded liability is expressed as the difference between the value of assets and the cost to meet all future obligations. Like any situation which is based on the time value of money, the more money one can set aside in earlier years the easier it is to meet a later obligation. A large liability over 40 years is more easily addressed by funding it at a much smaller amount in the earlier years than waiting until the liabilities actually accrue.

Once an election is made by the current defined benefit plan participants, the unfunded actuarial liability would then be calculated. This liability could be addressed by one or any combination of the following:

- Raise the employer contribution rate for the remaining defined benefit plan participants.
- "Lock in" inactive members or do not allow withdrawal of the employer contribution.
- Lower the employer contribution rate for defined contribution plan participants.
- One time or multi year special appropriation. ("Prime the pump")
- Raise the projected rate of return (not a recommendation).

6. How are the problems of inflation (and deflation) addressed?

In a defined benefit plan, theoretically, salaries increase with inflation although they do lag behind, especially in government employment. As salaries increase for covered employees, the employer and employee contribution rates, although steady, generate correspondingly greater income to the system. In addition, all of the fund's investments, being properly diversified, should equal or exceed the rate of inflation. If the real rate of return lagged behind inflation, the unfunded actuarial liability might increase and the taxpayers would have to pick up the difference.

In a defined contribution plan, again, although contribution rates might remain steady, the total contributions would increase with the salary base. However, because each employee account may vary in its range of investments, a given account may exceed, equal or fall behind the rate of inflation. Since there is no unfunded actuarial liability in a defined contribution plan, there would be no liability to the taxpayers to make up the difference.

In a deflationary cycle, wages would stagnate although government employee salaries have not historically decreased in relationship to the decline. In a defined benefit plan

the rate of return on total investments may fall and, if so, the taxpayer might have to make up the difference, usually through higher contribution rates. In a defined contribution plan wages, and hence contribution rates, would not in all likelihood fall but account balances could fall. All of the risks in this case would fall upon the employee and none upon the employer since there is no "shortfall" that would have to be made up.

7. **What are some of the tax implications in this defined benefit/defined contribution plan discussion?**

On the federal level, in both defined benefit/defined contribution plans, income tax on both the employer and employee contributions are tax deferred. Taxes are paid when funds are distributed.

In the current KPERS plan, the employee does pay state income tax on the contributions in the year in which the contributions are earned. However, benefits are exempt from state income tax when distributed. (This is similar to the relatively new Roth IRA).

Under H.B. 2718, the new defined contribution plan participants would be taxed for state income tax purposes the same as under the federal law, that is, contributions would not be subject to income tax at the time they were paid into the system but the benefits would be taxed on all plan distributions unless rolled over into another tax qualified plan. This bill would necessitate amendments to the tax code.

Any defined benefit plan participants converting to the defined contribution plan would have their contributions treated the same as under federal law, that is, prior contributions under the defined benefit plan would not be taxed at distribution under Kansas law. There is a precedent for this since before 1981 the law in Kansas was the same as the federal and, therefore, there are currently KPERS retirees whose distributions are taxed in two different ways, depending on when they were contributed to the system.

In 1998, Kansas income tax on employee KPERS contributions was $8.7 million. This would drop since all defined contribution plan participants after October 1, 2001, would have their contributions tax deferred. All employees continuing to contribute to the defined benefit plan would continue to pay Kansas income tax on their contributions but not on distributions. Although revenue would drop, it would not forever disappear. Due to that "time value of money" idea, the tax deferred accrual in the defined contribution plan participants' accounts could generate significantly more revenue than under current tax policy. This is certainly proving to be the case now as the WWII and baby boom generations move into retirement and start taking distributions of their tax qualified plans.

8. What about death and disability provisions?

Currently there are two death provisions and one disability provision in KPERS dealing with non-duty injuries. For active employees, the basic death benefit is equal to 150% of the annual rate of compensation and a return of contributions plus 4% interest. For retirees there is a lump sum payment of $4,000 and return of unused contributions plus 4% interest. As for disability, the system provides two-thirds of the annual rate of compensation with a 180 day waiting period, reduced however, by the amount of worker's compensation and social security that the retiree receives. It is important to note that this is funded separately from the retirement system with an employer contribution rate of .6% of payroll. There is no employee contribution for this program.

Under the defined contribution plan, the current death and disability plan could be continued or modified with group life or group disability options with any savings reallocated to reduce the defined benefit plan's unfunded liability.

Payout options on retirement would also differ significantly between the two plans. Under a defined benefit plan there are currently options for a life certain, joint and one-half, joint and full, and joint and three-fourths to survivor selections. Once the retiree selects an option, which is done at the time of retirement, the benefit is frozen in place. It is not unusual for retirees to guess wrong, that is, they outlive their "survivor" and there are also situations where neither one lives long enough to recoup the employee contribution, much less the employer contribution. In fact, if one stops and thinks, odds are (that is speaking actuarially) that many of the retirees will not recoup the employer and employee contributions that they have accrued over their lifetime.

In a defined contribution plan, the balance in the retiree's account is fully the property of the retiree. The retiree can die the day after retirement, or 40 years later, but whatever is in the account is theirs. The funds in the account will presumably continue to grow after retirement thus providing some hedge against inflation. The retiree can designate any beneficiary for the account upon his or her death.

One of the conferees did mention the "longevity risk" which is the risk that a retiree might "outlive" the funds in his or her defined contribution plan account. However, with the Social Security and Medicare continuing for the life of a retiree, and with proper planning (for example, long term care insurance) this scenario is unlikely unless the retiree did not participate in the plan for very many years or began covered employment late in life. However, these are problems not unique to state or local employees but are risks shared by anyone in the private sector.

9. **What are the relative costs of administration of defined benefit and defined contribution plans?**

Generally speaking, a defined benefit plan "costs" less. One reason is that there is no need to manage individual retiree/employee accounts and therefore the paperwork involved is less. The defined contribution plan can negotiate lower fees for its plan participants due to the relative size of the fund, but the fees would probably still be higher in the aggregate. To compare, the current cost of administration for KPERS is .057% of assets under investment vs. .8% for the State 457 plan.

I would point out that the rate is somewhat deceptive. In a defined contribution plan the administrative costs have a direct effect on the rate of return. However, in KPERS the lower administrative cost does not have any direct effect on the retirement benefit of any particular employee. Instead, it increases the "spread" between costs and return on investments and the benefit accrues indirectly by reducing the need for higher contribution rates or rates of return.

10. **What are the relative protections for employees and retirees under both systems?**

Under a defined benefit plan the full faith and credit of the State of Kansas guarantees the benefits. The losses incurred in the early 1990's had no effect on retiree benefits since those benefits are backed by the state. However, even public defined benefit plans which are under funded can be terminated and participants "cashed out" with available assets. Although legal, this might not be politically feasible. At one time, the teachers retirement system in Kansas was practically bankrupt and it continues to be the reason for the unfunded liability currently being addressed by KPERS almost 30 years after it was incorporated into KPERS.

Under the defined contribution plan, the state does not guarantee any minimum amount or return. House Bill 2718 requires that any fund manager be preselected by the KPERS Board of Trustees. All investment managers would, of course, be regulated by the U.S. Securities and Exchange Commission and regulated under the Securities Act of 1940.

11. **Could KP&F members participate in the defined contribution plan under H.B. 2718?**

No, not as currently drafted, although it could be amended to give those plan members the option. Since benefits under KP&F are significantly more generous than under standard KPERS, and contribution rates are therefore higher, it would seem unlikely that a current KP&F member, especially one who had been paying into the plan for some time, would elect to go into the defined contribution plan.

Not all police and firemen are in KP&F. Most smaller employers (county and city) have elected regular KPERS for their police and firemen, rather than KP&F. H.B. 2718 as drafted would allow those members to convert to the new system and all new hires would be put into the defined contribution plan.

12. Can the employer contribution rate be varied?

Yes. Under KPERS the state employer contribution rate, not including death and disability, has fluctuated from a high of almost 8% to a low of 3.1%. Under the proposed defined contribution plan the employer contribution rate cannot be decreased during a term of employment but could be decreased for new hires after a given date. As always, under either plan, the employee contribution rate can be increased or decreased, with certain restrictions.

13. Would the plan established by H.B. 2718 be compatible with other retirement plans in which an employee (for example, a teacher) might participate?

There is no flat prohibition on participation in other plans. There are maximum contribution limits on various plans and combinations of plans. (See Attachment A.)

14. What investment advice is available to employees and retirees?

Under the current defined benefit plan, KPERS designates an employee to be the local KPERS agent for a given employer. This agent is not paid by KPERS but is offered training by KPERS staff. The ability of these agents varies considerably from outstanding to poor. KPERS does have a telephone information line so that employees and retirees can submit inquires and receive advice. To be fair, investment advice to plan participants is simply not required in a defined benefit plan. However, due to the complexity of the defined benefit rules KPERS does spend a significant amount of staff time handling inquiries.

Under H.B. 2718, one factor in selection of a fund provider is that it provide education and "continuing investment counseling and retirement decision counseling" to plan participants.

15. What about legislator retirement plans?

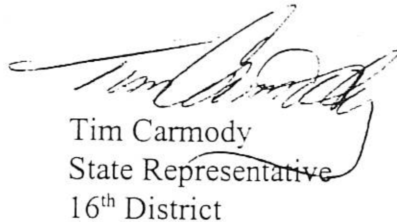
Because legislators participate in KPERS, they will also have the option to convert to the new plan.

16. What are some "intangible" factors in H.B. 2718?

- A defined contribution plan should be more beneficial in the hiring and retention of government employees than the current system.
- A defined contribution plan provides a much greater degree of portability of benefits than a defined benefit plan.
- A defined contribution plan may reduce or eliminate constant disputes over post-retirement employment and levels of compensation and issues associated with multiple employers.
- KPERS is older than much of the tax code. As such it has a "Rube Goldberg" complexity. A defined contribution plan is simple to understand, both in concept and in operation.
- Over time a new defined contribution plan will wean retirees from agitating for post-retirement cost of living adjustments which, as I have no need to remind you, are never funded by either the employer or the employee during their years of employment. This is like granting a retiree more money because they didn't put enough away during the term of employment. This concept is alien to a defined contribution plan. After all, Regents unclassified employees have not rallied on the courthouse steps for a cost of living adjustment for their retirees since they converted to a defined contribution plan many years ago.
- Please maintain a "one-time" option to convert to the defined contribution plan for current plan participants. As the plans develop over time there will be agitation to reopen the window. To reduce the possibility, consider establishing a penalty to discourage transferring.

Conclusion - H.B. 2718 is a win - win bill. It is a win for the government employees and it is a win for taxpayers. I urge your support.

Respectfully,



Tim Carmody
State Representative
16th District

TC:jb

SNAPSHOT COMPARISON OF GOVERNMENTAL RETIREMENT PLANS UNDER INTERNAL REVENUE CODE

Code Section	Taxation	Contribution Limits	Benefits Limits	Distribution Forms
401(a) Defined Benefit	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	Employee contributions limited to lesser of $30,000 or 25% compensation	$135,000 year, but can pay more through QEBA	• Rollovers to IRA or qualified plan • Lifetime annuity guaranteed by Fund • Lump sum available • Disability Benefits • Death Benefits • Health Benefits Account
401(a) Defined Contribution	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	Lesser of $30,000 or 25% compensation for employees and employer contribution	N/A	• Rollovers to IRA or qualified plan • Lump sum • Periodic payments available • Guaranteed lifetime benefit available through commercial annuity • Health Benefits Account

Code Section	Taxation	Contribution Limits	Benefits Limits	Distribution Forms
401(a) Hybrid Plan	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	Contribution limits will apply to defined contribution-like features	Generally structured to use defined benefit limits	Rollovers to IRA or qualified plan • Lifetime annuity guaranteed by Fund • Lump sum available • Disability Benefits • Death Benefits • Health Benefits Account
403(b) Tax Sheltered Annuity	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	• $10,500 on voluntary employee contribution (salary reduction) • Lesser of $30,000 or 25% compensation for employee and employer contribution • Maximum exclusion allowance for employee and employer contribution	N/A	• Rollovers to IRA or 403(b) plan • Lump sum • Periodic payments • Guaranteed lifetime benefits available through commercial annuity • Can add periodic payments
457(b) Deferred Compensation Plan	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	$8,000 or 33 1/3% of includible compensation for employer and employee contribution	N/A	• Transfers to other 457 plans • Lump sum • Periodic payments • Guaranteed lifetime benefits available through commercial annuity

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