

MINUTES OF THE HOUSE PENSIONS & BENEFITS COMMITTEE

The meeting was called to order by Chairman Mitch Holmes at 9:05 a.m. on March 7, 2011, in Room 142-S of the Capitol.

All members were present except:

Representative Charlie Roth - Excused

Committee staff present:

Gordon Self, Office of the Revisor of Statutes

David Wiese, Office of the Revisor of Statutes

Julian Efird, Kansas Legislative Research Department

Michael Steiner, Kansas Legislative Research Department

Darla Conner, Committee Assistant

Conferees appearing before the Committee:

Kenneth Daniel, Jr., Chairman of the Board of Midway Wholesale

Dave Trabert, President, Kansas Policy Institute

Terry Forsyth, Coalition for Keeping the Kansas Promise

Ron Gardner, The Kansas Coalition of Public Retirees

Diane Gjerstad, Wichita Public Schools USD 259

Others attending:

See attached list.

David Wiese, Office of the Revisor of Statutes, circulated to the committee members a bill briefing on **HB 2311**.

Hearing on:

HB 2311 - Enacting the Kansas public employees retirement system defined contribution act.

Proponents:

Kenneth Daniel, Jr., Chairman of the Board of Midway Wholesale, (Attachment 1), appeared before the committee in support of **HB 2311**.

Dave Trabert, President, Kansas Policy Institute, (Attachment 2), gave testimony before the committee in support of **HB 2311**.

Karl Peterjohn, Third District Sedgwick County Commissioner, (Attachment 3), presented written testimony in support of **HB 2311**.

John R. Todd, Wichita, Kansas, (Attachment 4), presented written testimony in support of **HB 2311**.

Opponents:

Terry Forsyth, Coalition for Keeping the Kansas Promise, (Attachment 5), presented testimony before the committee in opposition to **HB 2311**.

Ron Gardner, The Kansas Coalition of Public Retirees, (Attachment 6), gave testimony before the committee in opposition to **HB 2311**.

Gary D. Adkins, Executive Director of State Employees Association of Kansas, (Attachment 7), presented written testimony in opposition to **HB 2311**.

There being no further conferees, the hearing on **HB 2311** was closed.

Hearing on:

HB 2333 - Normal retirement date under KPERS.

Opponents:

Terry Forsyth, Coalition for Keeping the Kansas Promise, (Attachment 8), appeared before the committee in opposition to **HB 2333**.

Diane Gjerstad, Wichita Public Schools USD 259, (Attachment 9), gave testimony before the committee in opposition to **HB 2333**.

CONTINUATION SHEET

The minutes of the House Pensions & Benefits Committee at 9:05 a.m. on March 7 , 2011, in Room 142-S of the Capitol.

Hearing closed on **HB 2333**.

The next meeting is scheduled for March 9, 2011.

The meeting was adjourned at 10:25 a.m.

**HOUSE PENSIONS & BENEFITS
COMMITTEE GUEST LIST
DATE: March 7, 2011**

NAME	REPRESENTING
RON GARDNER	KCPR
KEN DANIEL	MIDWAY WHOLESALE
Stephanie Buntin	Judicial Branch
Jane Carter	KOSE
Levi Henry	KKP
Terry Forsyth	KNEA
Dave Trebant	KPS
Muhlel Butler	Cap. Strategies
ERDIE Clandel	KCPR
John U. Br...	INB
Don Gachas	TIAA - CREF
Dennis Phillips	KSCFF
Ed Redmon	KSCFF
Mindy Brissey	AFT - Kansas
Brian R. Thompson	PERAK
Ed Kumper	KACP/KSN/KPOA
GARY ADKINS	SEAK

**HOUSE PENSIONS & BENEFITS
COMMITTEE GUEST LIST
DATE: March 7, 2011**

NAME	REPRESENTING
Randy Seiver	SAPG-VALIC
Tom Kuhn	KRSB
Nicole Prouty Aiken	LKM
Kelly Navinsky-Wenzel	Kearney & Assoc.

TESTIMONY TO THE HOUSE PENSIONS AND BENEFITS COMMITTEE

House Bill 2311

By Kenneth L. Daniel, Jr.

March 7, 2011

Kenneth Daniel is the Founder and Chairman of the Board of Midway Wholesale. Midway is headquartered in Topeka and has locations in seven other Kansas cities plus one in Nebraska. For the past fifteen years, he has been an advocate for small businesses.

Mr. Chairman and Members of the Committee:

The total number of “defined benefit” pension plans dropped from 175,000 in 1983 to 83,600 in 1993, and has continued to drop precipitously except for union and public sector jobs.

The total number of “defined contribution” plans increased from 208,000 in 1975 to 618,500 in 1993 and has continued to increase steeply for public sector jobs except union jobs.

The Kansas Public Employees Retirement System is underfunded by an estimated \$7.7 billion.

The underlying cause of the underfunding problem is “defined benefit” pension plans. At all levels of government, politicians and administrators have “guaranteed” overly generous benefits while pushing the costs onto private businesses and private individuals and future generations of taxpayers.

Only by following the private sector’s lead and switching workers from a defined-benefit pension system to a defined-contribution can this mess begin to be fixed.

In addition to the fact that the defined benefit pension system will bankrupt Kansas government, there is the matter of fundamental fairness to the rest of the population that do not participate in public pensions.

In the first place, private pensions in Kansas are subject to state income tax, while public pensions are not. Furthermore, continuing to raise taxes on private business, private salaries, and future generations while increasing public pension benefits is fundamentally unfair and very damaging to the Kansas economy.

Add to this unfairness the frequent increases in benefits, the “13th check”, the short times of employment needed to qualify for many of these pensions, and the fact that the benefits are bloated by basing them on the last years of employment instead of all years of employment.

The Kansas Legislature and local and state officials have imposed a very heavy burden for the private citizens of Kansas to bear. Much of that cannot be reversed, but House Bill 2311 can begin the process of slowing the growth of this problem. I encourage you to support House Bill 2311.

House Pensions & Benefits

Date: 3/7/2011

Attachment # 1



KANSAS POLICY INSTITUTE

ADVOCATING FOR FREE MARKETS AND THE PROTECTION OF PERSONAL LIBERTY

Testimony Submitted to House Committee on Pensions and Benefits HB 2311 Kansas Public Employees Retirement System Defined Contribution Act March 7, 2011

Dave Trabert, President, Kansas Policy Institute

Chairman Holmes and Members of the Committee,

Thank you for the opportunity to testify today. It is an honor and privilege to be able to answer your questions and provide assistance as you examine options to address the very serious funding gap in (KPERS).

As detailed in "A Comprehensive Reform of the Kansas Public Employees Retirement System" by Dr. Barry Poulson, the real unfunded KPERS liabilities could exceed \$10 billion if estimated investment returns are not met.¹ The actuarial value of plan assets puts the funding gap at \$7.6 billion but, as disclosed by KPERS' actuaries, does not include \$1.7 billion in losses incurred but not yet recognized. The funding gap based on the market value of plan assets is therefore \$9.3 billion.

The complete reality is much worse and will be outlined in more detail later in my testimony, as will the wide disparity between the benefits enjoyed by public employees and private sector employees. These two facts demand the attention of the Legislature and make it clear that the reforms contained in HB 2311 should be enacted sooner rather than later. In fact, the longer the delay in implementing HB 2311, the worse the impact will be.

Both estimates are based on an assumed annual rate of return of 8 percent. Many experts consider an 8 percent return to be too high based on current market conditions. In fact, KPERS Executive Director has already told legislators that they are considering reducing their investment return assumptions to somewhere between 7 and 8 percent. KPERS actuaries estimate that a half-point reduction to 7.5 percent would increase the unfunded liability by \$1.3 billion, which would bring the total unfunded liability based on the market value of assets to \$10.6 billion.

As noted by Dr. Poulson, *"Given the magnitude of unfunded liabilities in KPERS, the employer contribution rates that would be required to meet these pension obligations and the economic*

House Pensions & Benefits

Date: 3/7/2011

Attachment # 2

¹ Kansas Policy Institute, released March 7, 2011.

consequences of meeting the future cost of the existing defined benefit plan would be severe. Employers in the state/school plan currently contribute 9.37 percent of payroll. To fully fund that part of the plan at the market value of assets employers would have to contribute 15.26 percent of payroll. Employer contributions into the state/school plan would have to increase from \$393 million to \$640 million annually, a two thirds increase. Kansas legislators are not likely to find an additional \$247 million in the current budget to fully fund the KPERS pension plan; and they are even less likely to find the money to fully fund the plan in future years as unfunded liabilities accumulate, especially if the plan fails to generate the projected 8 percent rate of return on assets. Kansas must enact pension reform quickly to ensure the future viability of the system and to prevent catastrophic funding shortfalls in the near future.

The cost of the current system is unsustainable, largely because plan benefits are unjustifiably high. While the plan was underfunded in past years, the impact on taxpayers would be similar regardless of when payments were made. If higher contributions were made in the past, taxes would have been hundreds of millions higher or spending would have been reduced by the same amount. The hardship of playing catch-up may be felt more severely, but even funding the plan sooner would have produced very negative consequences to taxpayers.

Government benefits in general are much more generous than those received by private sector workers. A study published by the American Legislative Exchange Council (ALEC) showed that state and local government workers receive much higher pay and benefits.² The following data summarizes the findings presented in Table 1 and Table 2 of that study.

Table 1: Pay Per Hour Worked			
	State & Local Government	Private Industry	Percent Gov't. Exceeds Private
Wages & salaries	\$26.11	\$19.41	34.5%
Retirement	\$3.19	\$0.92	246.7%
Health insurance	\$4.45	\$2.01	121.4%
All other benefits	\$5.85	\$5.08	15.2%
Total compensation	\$39.60	\$27.42	44.4%
<i>Source: Bureau of Labor Statistics; Other Benefits includes benefits such as life insurance, disability, social security, vacation and other paid leave</i>			

Defined benefit plans are much more expensive than defined contribution plans and most government workers are enrolled in defined benefit plans. Nationwide, 79% of state and local

² Public Employee "Other Post Employment Benefit" Plans – A Case for Shifting to a Defined-Contribution Approach, American Legislative Exchange Council, Barry W. Poulson and Arthur P. Hall, 2011, page 7-8.

government workers participate in defined benefit plans and 17% are in defined contribution plans; participation for private industry employees is 20% and 43%, respectively.³

According to KPERS, most employees contribute 4% of their pay (in after-tax dollars). The actuarially required employer rate for the state/school plan based on the market value of assets is 15.26% and is expected to rise. Employers currently aren't putting that much into the plan but eventually they will be forced to do so.

Reports that the average KPERS pension is only about \$1,100 per month are grossly distorted. Total payouts divided by total recipients will yield a low number because the majority of recipients have very few years of service. Those who have worked most of their career in government, however, receive pensions much more generous than the typical taxpayer.

Pension benefits are calculated by formula: Final Average Salary (FAS) times years of service times a statutory multiplier. FAS is the greater of (a) average of the highest three years of base earnings or (b) average of the highest 4 years of total earnings, which includes overtime, supplemental pay, bonuses, etc. The multiplier is 2.5% for Police and Fire, 3.5% for judges and 1.75% for everyone else.

Assuming a retiree meets minimum age requirements and doesn't elect options to take one-time lump sum distributions or to have a partial pension continue to a surviving spouse, someone with 30 years of service retiring from the state/school KPERS plan would collect 53% of FAS (30 times 1.75%); 35 years of service would generate 61% of FAS. There are no maximum years of service or percent of FAS for members of the state/school plan. The maximum % of FAS for KP&F members is 80% and for Judges, it's 70%.⁴

An employee retiring under the state/school plan with Final Average Salary of \$75,000 and 35 years of service would receive an annual pension of \$45,938 in addition to Social Security benefits. KPERS pensions are also not subject to state income tax, which further increases the value. The total income tax benefit to KPERS retirees is estimated at \$52 million per year.⁵

The KPERS system is already in an unsustainable funding crisis and creating a defined contribution plan for new hires is one important step that must be taken to ensure the future viability of the system. The concept contained in HB 2311 is very similar to many private sector plans and would provide benefits at least comparable to most other taxpayers.

³Ibid, page 9.

⁴ Kansas Policy Institute, "A Comprehensive Reform of the Kansas Public Employees Retirement System", Dr. Barry Poulson, March 2011, Appendix 2.

⁵ Ibid.

Dr. Poulson has also reviewed HB 2311 and had this to say: *"HB 2311 is an excellent bill requiring new hires to enroll in a defined contribution plan. As I understand it actuaries are conducting an analysis of the proposed plan. I hope that they project unfunded liabilities, funding ratios, and contribution rates with and without the plan. My expectation is that these projections will show that the Kansas pension plan is in worse shape than the Utah Plan. If I am right the actuarial analysis will reveal the need for even more comprehensive reforms."*

Those more comprehensive reforms outlined in Dr. Poulson's paper include:

- Increasing employee contribution rates
- Decreasing Cost of Living (COLA) adjustments
- Increasing vesting requirements
- Modifying the salary base and multiplier used to calculate Final Average Salary (FAS)
- Increasing the retirement age and years of service required to qualify for retirement benefits

We agree with Dr. Poulson and encourage the Committee to enact HB 2311 as the first important step of comprehensive pension reform.



A COMPREHENSIVE REFORM OF THE KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

Barry W. Poulson, Ph. D.
Professor of Economics (ret)
University of Colorado

March, 2011



**KANSAS POLICY
INSTITUTE**



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Kansas Policy Institute is an independent non-profit organization that advocates for free markets and the protection of personal freedom. Our work is focused on state and local economic issues in Kansas with particular emphasis on education, fiscal policy and health care. KPI empowers citizens and legislators with credible research and creative ideas to promote a low-tax, pro-growth environment that preserves the ability to provide high quality services. In addition to publishing issue-specific policy analysis and research, KPI also operates several web sites that specialize in investigative journalism, state capital news reporting, transparency in government spending and plain language descriptions of actions taken by the Kansas Legislature.

Guarantee of Quality Scholarship

Kansas Policy Institute is committed to delivering the highest quality and most reliable research on state and local issues in Kansas. KPI guarantees that all original factual data are true and correct and that information attributed to other sources is accurately represented.

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About the Author

Barry W. Poulson, Ph.D., is a professor (retired) at the University of Colorado - Boulder and is the past president of the North American Economics and Finance Association. Additionally, he has served as a visiting professor at universities around the world including the University of North Carolina, Cambridge University in England, and Konan University in Japan.

Beyond academia, Dr. Poulson has served in advisory roles to government and elected officials as a member of the Colorado Tax Commission, Vice Chair of the State Treasurer's Advisory Group on Constitutional Amendments, and a member of the Commission to Strengthen and Secure the Public Employees Retirement Association. Dr. Poulson also serves in scholarly roles with Americans for Prosperity Foundation, the Heritage Foundation, the Independence Institute, and the American Legislative Exchange Council.

He is the author of numerous books and articles on a variety of economic topics and his "Taxpayer's Bill of Rights" model legislation has been considered by many different state legislative bodies.

Executive Summary

The extent of Kansas' public employee retirement system funding crisis is likely to be considerably worse than commonly understood. KPERS uses actuarial asset values to estimate unfunded liabilities in the plan at \$7.6 billion, which puts the funded ratio at 64% (actuarial asset value divided by actuarial liabilities). However, the (permitted) method used to calculate the actuarial value of assets does not fully account for market activity, allowing for market losses to be recognized over a period of years rather than as they occur. The actuarial asset values do not include \$1.7 billion in real losses that have already occurred. Using the current market value of assets as disclosed by KPERS, unfunded liabilities are \$9.3 billion and the funding ratio falls to 56%.

Unfortunately, the true nature of the unfunded liability is likely much worse. KPERS assumes an 8 percent rate of return on assets, which even they now acknowledge is unlikely and are considering lowering the assumed rate of return on assets. Their actuaries estimate that lowering the assumed rate of return from 8 percent to 7.5 percent would increase unfunded liabilities by another \$1.3 billion.

Given the magnitude of unfunded liabilities in KPERS, the employer contribution rates that would be required to meet these pension obligations and the economic consequences of meeting the future cost of the existing defined benefit plan would be severe. Employers in the state/school plan currently contribute 9.37 percent of payroll. To fully fund that part of the plan at the market value of assets employers would have to contribute 15.26 percent of payroll. Employer contributions into the state/school plan would have to increase from \$393 million to \$640 million annually, a 63 percent increase. Kansas legislators are not likely to find an additional \$247 million in the current budget to fully fund the KPERS pension plan; and they are even less likely to find the money to fully fund the plan in future years as unfunded liabilities accumulate, especially if the plan fails to generate the projected 8 percent rate of return on assets.

Kansas must enact pension reform quickly to ensure the future viability of the system and to prevent catastrophic funding shortfalls in the near future. This study proposes a menu of comprehensive reform of the KPERS plan based on successful pension reforms enacted in other states.

- **Freezing participation in the existing defined benefit pension plan and requiring new employees to enroll in a defined contribution plan, or in a hybrid plan offering a defined contribution and defined benefit plan.**
- **Increasing Employee Contribution Rates**
- **Decreasing Cost of Living (COLA) Adjustments**
- **Increasing the Retirement Age and Years of Service Required to Qualify for Retirement Benefits**
- **Increasing Vesting requirements**
- **Modifying the Salary Base and Multiplier Used to Calculate Final Average Salary (FAS)**

Introduction

The Kansas Public Employees Retirement System (KPERs) is experiencing a funding crisis. The recent collapse of financial markets has resulted in a significant decrease in the value of the KPERs portfolio. But, the funding crisis in KPERs is not just the result of problems in financial markets. The problems in this defined-benefit pension plan have emerged over several decades, and are symptomatic of the poor incentive structure guiding the governance of many defined-benefit public pension plans. The financial market turmoil has exacerbated these problems, but KPERs is facing a long-run deterioration in its funding status.¹

The Kansas legislature has enacted several reforms over the past decade to address the KPERs funding problems. These reforms have included changes in benefits, increased contribution rates, and administrative changes. Unfortunately, these reforms have failed to address the fundamentally flawed incentive structure built into the KPERs defined benefit plan.

This year Governor Brownback and the leadership in the Kansas Legislature have set a high priority on reforming KPERs. It is clear that reducing and eliminating the unfunded liabilities in the pension plan are essential to solving the structural deficit in the Kansas budget.

This study proposes a comprehensive reform of the KPERs plan. Kansas can learn from the successful pension reforms enacted in other states. The most important of these reforms is to freeze participation in the existing defined benefit pension plan and require that new employees enroll in a defined contribution plan, or in a hybrid plan offering a defined contribution and defined benefit plan. Kansas should also follow the lead of other states by reducing the retirement benefits for current and future employees, and also for retirees to the extent legally permitted, including Cost of Living modifications.

The first part of the study examines the funding crises facing KPERs. The second part of the study analyzes pension reforms enacted in other states, focusing on Utah which recently froze participation in the defined benefit plan and requires new employees to enroll in a hybrid plan. This includes analysis of reforms in other states reducing pension benefits for current employees and retirees as well as new employees. The study concludes with a discussion of the need for comprehensive pension reform in Kansas.

¹ Barry W. Poulson and Arthur P. Hall, 'The Funding Crises in the Kansas Public Employees Retirement System', Technical Report 09-0904, Center for Applied Economics, University of Kansas, September, 2009.

KPERS, A Retirement System in Crisis

The Government Accounting Standards Board (GASB) sets standards for reporting pension plans offered by state and local governments. Unfunded liabilities in pension plans must be reported as debt in financial statements of state and local jurisdictions. Further, these standards require that state and local governments show progress toward eliminating unfunded liabilities over a 30-year amortization period. If pension plans fail to meet these standards, actuaries must report that the plans are not in actuarial balance. Bond rating agencies, such as Standard and Poor's, take this information into account in rating the bonds issued by state and local government.

GASB standards require that pension funds report two schedules of information regarding the funding status of the plans: (1) The Schedule of Funding Progress and (2) The Actuarial Contribution Rate.

The Schedule of Funding Progress

KPERS assumes that it will earn an eight percent return on assets in the long run. This estimated return on assets is used to determine the actuarial value of assets. KPERS sets a range around the actual market value of assets. The estimated actuarial value of assets can be no less than 80 percent and no more than 120 percent of the actual market value of assets.²

The asset smoothing methodology determines the timing when actual market experience is recognized in the financial statements. Unfunded liabilities not recognized in the current accounting period will be recognized in financial statements in future years. Since employer contribution rates are set based on the actuarial value of assets in the current accounting period, some of the losses in the current accounting period are deferred to future years.

Table 1 shows that on December 31, 2009 KPERS reported an actuarial value of assets \$1.7 billion greater than the market value of the same assets. The funding ratio of KPERS was 55.9% based on the market value of assets, compared to 64.0% based on the actuarial value of assets.

Table 2 shows the funded ratio and the unfunded actuarial liability using both the market value of assets and the actuarial value of assets over the past 6 years. The unfunded actuarial liabilities about doubled from \$4.7 billion to \$9.4 billion in the past six years using the market value of assets. The funding ratio fell to 56 percent based on the market value of assets.

The unfunded liability in the KPERS system is equal to about 8 percent of state gross domestic product. To put this in perspective, the total state debt in Kansas is equal to about 5 percent of gross state product.

Table 1. KPERS Unfunded Liabilities and Funding Ratio Using Market and Actuarial Value of Assets, December 31, 2009.

	Market Value of Assets	Actuarial Value of Assets
Actuarial accrued liability	\$21.1 billion	\$21.1 billion
Assets held to pay those liabilities	11.8 billion	13.5 billion
Unfunded actuarial accrued liability	9.3 billion	7.6 billion
Funding Ratio	55.9%	64.0%

Source: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 pp. 72-74

² Comprehensive Annual Financial Report for the Fiscal Year Ended June 30 2010, pp.72-74.

**Table 2. Unfunded Liabilities and Funding Ratio
Using Market and Actuarial Value of Assets**

	2004	2005	2006	2007	2008	2009
Using Market Value of Assets						
Funded Ratio	71%	72%	76%	75%	49%	56%
Unfunded Actuarial Liability	\$4,742	\$4,543	\$4,184	\$4,817	\$10,250	\$9384
Using Actuarial Value of Assets						
Funded Ratio	70%	69%	69%	71%	59%	64%
Unfunded Actuarial Liability	\$4,743	\$5,152	\$5,364	\$5,552	\$8,279	\$7677

Source: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p73.

Using the actuarial value of assets rather than the market value of assets shows less deterioration in the funded status of the system over the past year. However, asset smoothing impacts only

the timing of when the actual market experience of assets is recognized. The actuarial value of assets exceeds the market value of assets by 14 percent. This means that \$1.7 billion in unfunded liabilities is not recognized in these financial statements and will only be recognized in financial statements in future years.

The Actuarial Contribution Rate

The actuarial process is the basis for determining employer and employee contributions into the pension plan. To meet GASB standards, the pension plan must calculate an actuarial contribution rate that will eliminate unfunded liabilities in the system within a 30-year amortization period. The actuarial contribution rate is a schedule of employer contributions required to meet this standard. The actuarial contribution rate includes two components:

- A 'normal cost' for that portion of projected liabilities allocated by the actuarial cost method for service of members during the year following the valuation date.
- An 'unfunded actuarial contribution' to cover the excess of projected liabilities over the actuarial value of assets.

The Annual Required Contribution Rate (ARC) is the employer contribution rate required to meet the maximum 30-year amortization standard.

The Kansas pension system is unique in that a statutory cap is placed on the annual increase in employer contribution rate. As a result of legislation enacted in 1993, the KPERS system calculates a statutory contribution rate. The purpose was to set statutory payments as a level percentage of payroll to pay off unfunded liabilities in the system over a 40-year amortization period. The legislation set a cap on the amount by which the statutory contribution rate could increase each year. The statutory cap has been increased in recent years, from .20 to .40 percent in FY 2006, .50 percent in FY 2007, and .60 percent in FY 2008 and beyond. As a result the actuarial contribution rate exceeds the statutory rate in the state, school, and local plans.³

Due to these statutory caps, the statutory contribution rates for State, School, and Local employers have fallen well below the actuarial contribution rates. As reported in Table 3, the

³ Kansas Public Employees Retirement System, Valuation Report as of December 31, 2008, pp.6-7.

shortfall between these rates is 0.18 percent, 5.32 percent, and 2.10 percent, respectively, for the State, School and Local Systems.⁴

The investment losses in 2008 have caused a serious deterioration in the funded status of the KPERS system. As previously noted, \$1.7 billion of these losses are not accounted for in estimating the above actuarial contribution rates due to the smoothing of asset values. To underscore the impact of these market losses, contribution rates are calculated based on the market value of assets. Table 4 compares the actuarial contribution rates with these contribution rates based on market values of assets. Using market valuation of assets, the employer contribution rate for the State/ School System would have to increase to 15.3 percent. The employer contribution rate for the Police and Fire System would have to increase to 19.8 percent.⁵

Given the magnitude of unfunded liabilities in KPERS, the employer contribution rates that would be required to meet these pension obligations and the economic

consequences of meeting the future cost of the existing defined benefit plan would be severe. Currently employers in the state/school plan contribute 9.37 percent of payroll. To fully fund that part of the plan at the market value of assets, employers would have to increase from from \$393 million to \$640 million, a 63 percent increase.⁶ (Data required to calculate

Table 3. KPERS Actuarial and Statutory Contribution Rates, December 31, 2009 Valuation

System	Annual Required Contribution	Statutory	Difference
State	9.55%	9.37%	0.18%
School	14.69%	9.37%	5.32%
Local	9.44%	7.34%	2.10%
Police and Fire	16.54%	16.54%	0%
Judges	23.75%	23.75%	0%

Source: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p74. For KP&F, the statutory contribution rate is equal to the "uniform" rate. The rate shown is for local employers. The rate for State employers is 16.43 percent this year, which includes a payment of 0.51 percent for the debt service payment on the bonds issued for the 13th check. The uniform rate does not include the payment required to amortize the unfunded past service liability or any 15 percent excess benefit liability determined separately for each employer.

Table 4. Contribution Rates Using Actuarial and Market Valuations, December 31, 2009 (Dollars in Millions)

	State/School		KP&F	
	Actuarial	Market	Actuarial	Market
Actuarial Liability	\$15,141	\$15,141	\$2,232	\$2,232
Asset Value	9,329	8,130	1,701	1,485
Unfunded Actuarial Liability	5,812	7,011	530	747
Funded Ratio	62%	54%	76%	67%
Contribution Rate				
Normal Cost Rate	8.54%	8.54%	14.71%	14.71%
Unfunded Actuarial Liability Pymt.	9.00%	10.79%	8.17%	11.61%
Total	17.54%	19.33%	22.8%	26.32%
Employee Rate	4.07%	4.07%	6.52%	6.52%
Employer Rate	13.47%	15.26%	16.36%	19.80%

Source: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p78.

4 Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p74.

5 Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p78. Note that Table 4 does not include the local and judges' pension plans so the unfunded liabilities reported in Table 4 differ from that in Table 2 that includes all plans.

6 The current statutory employer contribution rate for the state/school system is 9.37 percent of covered payroll. Page 38 of the KPERS CAFR says covered payroll for FY 2010 was \$4,190,789,000. Based on FY 2010 covered payroll, state/school employers would contribute \$393 million at the statutory rate of 9.37 percent. To fully fund the state/school plan at the market value actuarially required contribution (ARC) rate of 15.26 percent of covered salary, employers in the state/school plan would have to increase their contribution to \$640 million annually, which is a \$247 million increase.

required funding increases in the local, KP&F and Judges plans are not available.) Kansas legislators are not likely to find an additional \$247 million in the current budget to fully fund the KPERS pension plan; and they are even less likely to find the money to fully fund the plan in future years as unfunded liabilities accumulate, especially if the plan fails to generate the projected 8 percent rate of return on assets.

Actuaries have provided projections of the actuarial and statutory rates for each of these plans. It should be emphasized that these projections are based on the actuarial assumptions in these plans, including the assumption of an 8 percent return on the value of assets in the plans.

The actuaries assume that the statutory contribution rates will increase over the amortization period at the rate imposed by the statutory cap. The statutory rates for the state and local plan increase and converge with the actuarial rate in 2018 and 2019 respectively. However, the statutory rate for the school plan is not projected to converge with the actuarial rate within the amortization period. Over the amortization period the statutory rate for the school plan increases from 8 percent to 20 percent, while the actuarial rate increases from 12 percent to 24 percent. Unfunded liabilities in the school plan increase over the amortization period.⁷

As the KPERS actuaries conclude, the plan continues to face significant funding challenges, even if the actuarial assumptions are met. If the plan does not generate the assumed 8 percent rate of return on assets it is highly likely that the Kansas pension fund will face a funding crisis. Although the investment return was strong in 2009, the plan has not recovered from the loss on assets incurred in 2008. As these deferred losses are recognized over the next few years the gap between the actuarial and statutory rates will increase, unfunded liabilities will accumulate, and the funding ratio will deteriorate.⁸

KPERS directors are well aware of the potential for a funding crisis in the plan. They are considering lowering the assumed rate of return on assets from 8 percent to something between 7 and 8 percent. Their actuaries estimate that lowering the assumed rate of return from 8 percent to 7.5 percent would increase unfunded liabilities \$1.3 billion. As KPERS Executive Director Glenn Deck told legislators when explaining their rationale, "just as in 2008 and 2009, the pension fund's unfunded liabilities could increase dramatically if markets suffer another downturn".⁹

Actuaries in Utah have provided projections of unfunded liabilities in the Utah retirement system under different assumptions regarding the assumed rate of return on assets. These projections reveal how sensitive the funding status of the plan is to the assumed rate of return on assets. They also reveal the potential for a funding crisis when the actual rate of return falls below the assumed rate of return. Given the current funding status of the Kansas plan there is a high probability that the plan will face a funding crisis over the next decade.

⁷ Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p74-78.

⁸ Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010 p77-78.

⁹ Gene Meyer, 'KPERS Directors Mull Major Investment Changes', KansasReporter.org <http://kansasreporter.org/70281.aspx>

What Can Kansas Learn from Pension Reform in Other States?

A funding crisis in the state pension plan is not unique to Kansas. The most recent estimates are that unfunded liabilities in state pension plans are in excess of \$2 trillion.¹⁰ Like Kansas, most states are not meeting required contributions in their pension plans so unfunded liabilities continue to accumulate and funding ratios in these plans deteriorate.

However, a number of states have successfully addressed the funding crises in their pension plans. Just as in the private sector, the most effective of these reforms is to freeze participation in defined benefit plans. Two states, Alaska and Michigan require new employees to enroll in a defined contribution plan. Eight states have replaced their defined benefit plan with a defined contribution plan, allowing new employees to enroll in a defined contribution plan, or in a hybrid plan including both defined contributions and defined benefits. These states include Florida, Georgia, Indiana, Nebraska, Ohio, Oregon, West Virginia, and Washington. Further, a number of states have enacted reforms to reduce the cost of existing defined benefit plans. Last year fifteen states enacted reforms to reduce the cost of their defined benefit pension plan.¹¹

The next section of this study will survey these reforms. The focus is on pension reforms enacted in Utah because thorough actuarial analysis provided a strong empirical basis for evaluating the need for reform and the potential impact of alternative reforms on their retirement system.

The Baseline Scenario

Actuaries in Utah projected unfunded liabilities in the Utah Retirement System for different scenarios. The baseline scenario assumes a 7.75 percent rate of return on assets in the plan.¹² This scenario also assumes that the state of Utah contributes the actuarial rate set by the Board of Trustees each

**Table 5. Baseline Scenario for Utah Defined Benefit Plan
(Assumed 7.75% Investment Returns)**

Fiscal Year	Contribution Rates		Actuarial Information		
	Employer Contribution Rate (Percent)	Actuarial Rate ARC (Percent)	Year	Unfunded Actuarial Accrued Liability UAAL (\$ Millions)	Funded Ratio (Percent)
			2008	511.2	96.5
FY2010	13.3	13.3	2010	2,326.1	85.8
FY2015	22.8	22.8	2013	5,687.2	70.5
FY2020	23.1	22.0	2018	5,969.7	75.3
FY2025	23.1	19.9	2023	5,679.9	80.6
FY2030	23.1	17.4	2028	4,679.7	86.6
FY2035	23.1	14.2	2033	2,494.3	93.9
FY2040	23.1	10.4	2038	-1,584.2	103.3
FY2045	11.7	5.9	2043	-8,609.2	115.0
FY2050	11.7	4.3	2048	-13,325.5	119.5

Source: Gabriel Roeder Smith & Company (2009), 'Information Requested by Committee for November 12th Meeting, Exhibit 2', Retirement and Independent Entities Committee, Utah Legislature, November 10.

¹⁰ Barry W. Poulson and Arthur P. Hall, 'State Pension Funds Fall Off a Cliff', The American Legislative Exchange Council, January 2010, pp.26-28

¹¹ National Conference of State Legislatures, 'Pension and Retirement Plan Enactments in 2010 Legislatures,' Nov. 17, 2010, pp2-21.

¹² Utah actuaries made a number of simplifying assumptions in these projections which are detailed in the study, Gabriel Roeder Smith % Co., Consultants & Actuaries, 'Actuarial Analysis: SB 63 (3rdsb.) – New Public Employee Tier II Contributory Retirement Act and New Public Safety and Firefighter Tier II Contributory Retirement Act, February 26, 2010.

Table 6. Scenario with a 6% Rate of Return on Assets

Fiscal Year	Contribution Rates		Actuarial Information		
	Employer Contribution Rate (Percent)	Actuarial Rate ARC (Percent)	Year	Unfunded Actuarial Accrued Liability UAAL (\$ Millions)	Funded Ratio (Percent)
			2008	511.2	96.5
FY2010	13.3	13.3	2010	2,363.9	85.6
FY2015	23.7	23.7	2013	6,167.6	68.0
FY2020	25.3	25.3	2018	7,904.8	67.3
FY2025	25.8	25.8	2023	9,736.5	66.8
FY2030	26.1	26.1	2028	11,913.8	65.8
FY2035	26.1	26.1	2033	14,450.5	64.8
FY2040	26.1	26.1	2038	17,385.6	64.1
FY2045	26.1	26.0	2043	20,761.8	63.8
FY2050	26.1	25.4	2048	24,593.8	64.0

Source: Gabriel Roeder Smith & Company (2009), 'Information Requested by Committee for November 12th Meeting, Exhibit 2', Retirement and Independent Entities Committee, Utah Legislature, November 10.

year over the forecast periods. As long as the plan is less than 110 percent funded, the contribution rate is the larger of (a) the annual required contribution rate (ARC) for the year, or (b) the prior year's contribution rate.

In the baseline scenario the contribution rate increases beginning in FY 2011, and continues to increase reaching a peak of 23.1 percent in FY 2016, after which the rate remains constant until the plan becomes 110 percent funded.

As in many states the Utah retirement plan incurred significant losses in 2008 which are spread over a five year period. Unfunded liabilities in the plan increase from about a half billion dollars in FY 2010 to about 6 billion dollars in FY 2020 and then decrease. The funded ratio decreases from 96.5 percent in FY2010 to 70.5 percent in FY 2013 and then increases.

The Impact of a Lower Rate of Return on Assets.

Utah actuaries project unfunded liabilities for different assumptions regarding the rate of return on assets.¹³ As you would expect, the funding status of the plan improves when assuming a higher rate of return. What proved to be surprising is how sensitive these projections are to lower rates of return on assets.

Table 6 shows projections based on a 6 percent rate of return on assets. In this scenario the employer contribution rate increases to a peak of 26.12 percent in FY 2035 and remains at that level. Despite this increase in the employer contribution rate the unfunded liabilities increase to 25 billion dollars in 2050. The funded ratio falls to about 64 percent.

The projections provided by actuaries were an impetus for reform of the pension plan in Utah. They revealed how sensitive the funding status of the plan is to assumed rates of return on assets. Many economists argue that the 8 percent rate of return on assets assumed in most state pension plans is highly unrealistic, and that a 6 percent rate of return or less is a more realistic assumption (see Appendix 1). As the Utah study reveals, the assumption of a lower rate of return means that these plans are likely to experience a major funding crisis over the amortization period.

¹³ Gabriel Roeder Smith & Co., Consultants & Actuaries, 'Information Requested by Committee for Nov. 12th Meeting, November 10, 2009.

A Hybrid Plan

As a result of this analysis Utah enacted a comprehensive reform of their pension plan.

The Utah reform has generated a great deal of interest because the state froze the existing defined benefit pension plan and replaced it with a hybrid plan that allows new hires to choose between a defined contribution plan and a hybrid plan.

• The Defined Contribution Component

The defined contribution component provided individual employee accounts into which employers contribute 10% of employee compensation for public employees, legislators, and the governor, and 12% for public safety and firefighter members. Employee contributions into the defined contribution component are voluntary. Employee contributions are immediately vested while employer contributions are vested after four years of employment. Once vested, employees can direct the investment of their contributions. These employer contribution rates are more generous than employer contribution rates in defined contribution plans in the private sector.¹⁴

• The Hybrid Component

The hybrid component includes a new defined benefit and defined contribution plan. The new hybrid defined benefit plan requires employer contributions up to 10% of employee compensation. Employees contribute any additional amount required to make the plan actuarially sound. Employee contributions are immediately vested. If an employee in this plan terminates employment prior to retirement, their contribution is held in an individual account for them or their beneficiary. Benefits in the defined benefit plan may not be increased until all the plans created by this legislation reach 100% of their actuarial funding requirement. Employers are required to make additional contributions needed to amortize liabilities in the existing defined benefit plan.

The new defined benefit plan provides reduced benefits for new hires compared to the existing defined benefit plan. The benefit formula for employees who retire at age 65 with 35 years of service is 1.5% of the final average salary (FAS) times years of service. FAS is the average of the highest five years of compensation. Reduced benefits are provided for early retirement or fewer years of service. The cost of living adjustment is the Consumer Price Index (CPI) up to a maximum of 2.5%. When the CPI exceeds 2.5% the excess is accumulated and applied to the cost of living adjustment in years when the CPI is less than 2.5%.

The hybrid plan includes a new defined contribution plan into which employers contribute 10% of employee compensation less the amount the employer contributes to the new defined benefit plan. This employer contribution is deposited into individual employee accounts. Employee contributions into these individual accounts are voluntary. Employee contributions vest immediately, and employer contributions vest after four years of employment. Employees direct the investment of their contributions immediately, and direct the investment of employer contributions once they are vested.

¹⁴ For a comparison of pension benefits in the public and private sector see Barry W. Poulson and Arthur P. Hall, 'Public Employee Other Post Employment Benefit Plans, A Case for Shifting to a Defined Contribution Approach,' American Legislative Exchange Council, 2011, pp 7-9.

Separate hybrid plans are created for public safety officers and firefighters, with higher employer contribution rates and earlier retirement ages for their defined benefit plans.

Actuaries estimate the cost of the defined benefit part of the hybrid plan at 7.62% of payroll. Since employers must contribute 10% to the plan that leaves 2.38% to go to the defined contribution part of the plan (a smaller amount is left for the separate hybrid plan for public safety officers and firefighters).

• Actuarial Analysis of the Hybrid Plan¹⁵

As new employees are enrolled in the hybrid plan employers begin to see savings compared to the existing defined benefit plan. Actuaries estimate that employers will contribute \$3.9 million less in FY 2012 and \$10.2 million less in FY 2013 into the hybrid plan compared to what they would have contributed to the existing defined benefit plan. Over time as employ-

ees in the hybrid plan increase relative to those enrolled in the existing defined benefit plan the relative savings will increase.

Table 7 projects contribution rates with the hybrid plan. There are significant savings with the hybrid plan compared to the baseline scenario for the existing defined benefit plan. Contribution rates into the defined benefit plan are lower and eventually decrease as the number of employees enrolled in the hybrid plan increase.

Employer contribution rates

are earmarked for amortization payments until unfunded liabilities are paid off within the amortization period. The total average employer contribution rates with the hybrid plan are lower than that for the existing defined benefit plan.

The employer contribution rate listed in Table 7 and Table 8 for the hybrid plan is set in Utah SB 63 (3rd Sub.). The third column of both tables shows the portion of that contribution allocated to paying off unfunded liabilities in the current DB plan. The average total employer contribution rate in the final column of Table 7 and Table 8 is the weighted average of employer contribution rates into the current DB plan and the hybrid plan. Toward the end of the time period relatively few employees are enrolled in the current defined benefit plan, decreasing the weight of that plan in the total average employer contribution rate.

**Table 7. The New Hybrid Plan
(Assumes 7.75% Investment Returns)**

Fiscal Year	Current DB Plan Employer Contribution Rate	Hybrid Plan for Future Hires Employer Contribution Rate	Amortization Payment Rate	Average Total Employer Contribution Rate
FY2010	13.3	na	na	13.3
FY2015	22.7	10.0	11.0	22.4
FY2020	23.1	10.0	11.4	22.3
FY2025	23.1	10.0	11.4	22.0
FY2030	23.1	10.0	11.4	21.8
FY2035	23.1	10.0	11.4	21.6
FY2040	23.1	10.0	11.4	21.4
FY2045	11.7	10.0	0.0	10.0
FY2050	11.7	10.0	0.0	10.0

Source: Gabriel Roeder Smith & Company (2010), 'Actuarial Analysis SB 63 (3rd) Sub., Exhibit 3, Utah Legislature, November 10.

¹⁵ Gabriel Roeder Smith % Co., Consultants & Actuaries, 'Actuarial Analysis: SB 63 (3rdsb.) – New Public Employee Tier II Contributory Retirement Act and New Public Safety and Firefighter Tier II Contributory Retirement Act, February 26, 2010.

A Defined Contribution Plan

As noted earlier two states, Alaska and Michigan have closed their defined benefit plan. New hires in those states are required to enroll in the new defined contribution plan. Much controversy has centered on the impact of this reform on the funding status of the retirement plans. It is important to note that in both Alaska and Michigan the funded ratio of their new retirement plan has increased since these reforms were introduced.

At the time that Utah introduced their hybrid plan they also considered replacing their defined contribution plan with a defined contribution plan for new hires. They asked actuaries to project the impact of such a reform on the funded status of the retirement system. While Utah chose not to enact this reform, their actuarial analysis reveals that this was a viable option to address the problem of unfunded liabilities in their retirement system.

• Actuarial Analysis of the Defined Contribution Plan¹⁶

In these projections the assumption is that the employer cost of the new defined contribution plan is capped at 8% of employee compensation. Employers are also required to contribute 8% of employee compensation for new hires earmarked for amortization payments. Thus, the employer contribution rate for new hires is 16% of employee compensation, with half going to the new defined contribution plan and half earmarked to pay off unfunded liabilities in the existing defined benefit plan.

Table 8. Defined Contribution Plan (Assumes 7.75% Investment Returns)				
Fiscal Year	Current DB Plan	DC Plan for Future Hires		Average Total
	Employer Contribution Rate	Employer Contribution Rate	Amortization Payment Rate	Employer Contribution Rate
FY2010	13.3	na	na	13.3
FY2015	26.7	8.0	8.0	24.4
FY2020	27.5	8.0	8.0	22.3
FY2025	26.9	8.0	8.0	20.0
FY2030	25.6	8.0	8.0	18.1
FY2035	45.5	8.0	8.0	19.5
FY2040	11.7	8.0	0.0	8.2
FY2045	11.7	8.0	0.0	8.0
FY2050	11.7	8.0	0.0	8.0

Source: Gabriel Roeder Smith & Company (2009), 'Information Requested by Committee for November 12th Meeting, Exhibit 14a', Retirement and Independent Entities Committee, Utah Legislature, November 10.

Table 8 projects the costs of this defined contribution plan.

During the initial years a relatively small share of the work force is represented by new hires in the defined contribution plan. For the first few year assets do not increase as fast as liabilities, and unfunded liabilities increase. However, by 2018 the growth of assets more than offsets the increase in liabilities and the funded ratio improves. The actuarial projections for the defined contribution plan in Utah are important to resolve a controversy regarding this reform. It is sometimes argued that replacing a defined benefit plan with a defined contribution plan for new hires is not viable because unfunded liabilities cannot not be paid off within the amorti-

¹⁶ Gabriel Roeder Smith % Co., Consultants & Actuaries, 'Information Requested by Committee for Nov. 12th Meeting, November 10, 2009.

Table 9. Unfunded Liabilities in the Defined Contribution Plan

Actuarial Information DC Plan

Year	Unfunded Actuarial Accrued Liability UAAL (\$ Millions)	Funded Ratio (Percent)
2008	511.2	96.5
2010	2326.1	85.8
2013	5485.6	71.5
2018	5205.5	77.8
2023	4369.4	83.7
2028	3053	89.4
2033	918.1	96.9
2038	-1377.48	104.9
2043	-2000.7	107.9
2048	-2905.7	113.5

Source: Gabriel Roeder Smith & Company (2009), 'Information Requested by Committee for November 12th Meeting, Exhibit 14b', Retirement and Independent Entities Committee, Utah Legislature, November 10.

zation period. These actuarial projections show that the unfunded liabilities are paid off at about the same pace within the amortization period with either the defined contribution plan or the hybrid plan.

A comparison of the Total Average employer contribution rates reveals that the hybrid plan is less costly than the current defined benefit plan over the amortization period. A similar comparison for the defined contribution plan reveals that this plan is more costly than the current defined benefit plan for the first five years, but is significantly lower in cost over the remaining amortization period.

It is clear from these actuarial projections that the most important reform states can enact to avoid a funding crisis is to freeze participation in defined benefit plans and create new plans with reduced benefits for new hires. The new plans can offer defined contribution plans or hybrid plans for new hires. As employees in the new plans replace the employees in the closed defined benefit plans unfunded liabilities can be reduced and eliminated.

Table 10. A Comparison of the Total Average Contribution Rates

Average Total Employer Contribution Rate

Fiscal Year	Baseline Scenario	Hybrid Plan	DC Plan
FY2010	13.3	13.3	13.3
FY2015	22.8	22.4	24.4
FY2020	23.1	22.3	22.3
FY2025	23.1	22.0	20.0
FY2030	23.1	21.8	18.1
FY2035	23.1	21.6	19.5
FY2040	23.1	21.4	8.2
FY2045	11.7	10.0	8.0
FY2050	11.7	10.0	8.0

Source: Tables 5-9.

Reforming Defined Benefit Plans

As the Utah study demonstrates, pension reform is needed even in states with relatively high funded ratios. Actuarial analysis in Utah revealed that the defined benefit plan was not viable. Employer contribution rates were projected to increase to 24% of employee compensation. If assets in the plan returned less than the 7.75% assumed rate of return the defined benefit plan would face a funding crises that could potentially bankrupt the state.

Utah's unfunded liability situation was not unique to that state. The only real difference in Utah is that they conducted actuarial studies to understand what the future would hold if nothing was done today.

Utah chose to enact reforms that did not modify benefits for employees currently enrolled in the defined benefit plan. New hires are required to enroll in either the new

defined contribution plan or hybrid plan, with reduced benefits. It is important to emphasize that Utah enacted these reforms freezing participation in a defined benefit plan with a relatively high funding ratio compare to that in most other state defined benefit plans.

Most states, including Kansas, have defined benefit plans with much lower funding ratios, and some of these states already face a funding crisis in their plans. Reducing and eliminating unfunded liabilities in these defined benefit plans in these states will impose a heavier burden.

Some states have increased taxes and issued debt to pay off unfunded liabilities, but there is growing taxpayer resistance to these policies. Taxpayers are challenging the increased taxes used to fund pension plans, and the increased share of budgets allocated to pension plans at the expense of government services. States such as Kansas with relatively high tax rates can ill afford additional tax burdens to fund their pension plans.

There is increased pressure for government employees to have benefit plans more in line with those of private sector taxpayers and to bear a greater share of the cost of pension plans, including current employees as well as new hires. A National Conference of State Legislatures survey reveals that many states have enacted reforms designed to increase cost sharing in pension plans by current employees and retirees as well as new hires.¹⁷

- **Increasing Employee Contribution Rates**

One reform is to require increased employee contributions into the defined benefit plan, with a portion of those contributions earmarked for amortization of unfunded liabilities. Some economists advocate matching contributions from employees and employers. This form of cost sharing means that current employees as well as new hires share in the cost of amortization payments used to pay off unfunded liabilities in the plan. Since benefits of the defined benefit plan accrue to current employees this cost sharing is viewed by some economists as a more equitable way to pay off unfunded liabilities in the plan.

Over the past year a number of states have required increased contributions from current employees enrolled in defined benefit plans, including: Colorado, Iowa, Minnesota, Mississippi, Vermont, and Wyoming. Colorado, for example, increased employee contribution rates into the defined benefit plan by 2.5% and decreased employer contribution rates by the same amount for FY 2011. As a result the state employee contribution rate increased from 8% to 10.5% of salary, while employer contribution rates decreased from 10.15% to 7.65%. Contribution rates were shifted from employers to employees for other government employees as well. This one time change in the defined benefit plan was estimated to save the state \$37 million.

Kansas has kept the contribution rate for current employees at 4 percent, but now requires new hires to contribute 6 percent.

A number of states increased employer and employee contribution rates into their defined benefit plans. In some states, such as Wyoming, these changes were designed to equalize the cost of defined benefit plans between employers and employees.

- **Decreasing Cost of Living (COLA) Adjustments**

Many states provide generous cost of living (COLA) adjustments for benefits in their defined benefit plans. In recent years a number of states have reduced or eliminated COLA adjustments to reduce the cost of their plans.

Michigan froze participation in their defined benefit plan and requires new hires to enroll in a new defined contribution plan or hybrid plan. The new hybrid plan eliminates COLA adjustments to benefits from the defined benefit portion of the plan.

¹⁷ National Conference of State Legislatures, 'Pension and Retirement Plan Enactments in 2010 Legislatures,' Nov. 17, 2010, pp2-21.

Some states have reduced the COLA adjustment for benefits received by retirees and well as current employees in the defined benefit plan. Colorado, for example, reduced the COLA to the lesser of 2% or inflation for 2010. For future years the COLA is limited to 2% unless the plan experiences a negative investment return, in which case the COLA is calculated as the lesser of inflation for the preceding 3 years or 2%. The new rules adjust the COLA based on the funded ratio in the plan.

Kansas has set the COLA rate for new hires at 2 percent.

- **Increasing Retirement Age and Years of Service Required to Qualify for Retirement Benefits**

Last year eight states increased the retirement age and years of service required to qualify for benefits in the defined benefit plan. In Missouri, for example, to be eligible for normal retirement benefits in their defined benefit plan employees must now reach age 67 and have at least 10 years of service, or reach age 55 with the sum of the employee's age and service equaling at least 90. The previous requirement was 62 years of age with 5 years of service, or the rule of 80 with a minimum age of 48. Many states have also imposed more restrictive rules for early retirement, and for rehired employees to qualify for benefits.

To be eligible for unreduced benefits KPERS uses an 85 Point Rule (age plus years of service must be equal to 85). To qualify for unreduced benefits employees hired prior to July 1, 2009 must meet one of the following criteria: age 65 with 1 year of service, or age 62 with 10 years of service. To qualify for unreduced benefits employees hired after that date must meet one of the following criteria: age 65 with 5 years of service, or age 60 with 30 years of service. All KPERS employees qualify for reduced benefits at age 55 with 10 years of service.

- **Increasing Vesting requirements**

Last year four states imposed more stringent requirements for employees to be vested in their defined benefit plans. In some states these new vesting requirements apply only to new hires, but in others they apply to all employees. Missouri and Pennsylvania have increased the vesting requirement from 5 years to 10 years for all employees.

KPERS has kept the vesting period for current employees at ten years, and reduced it for new hires to five years.

- **Modifying the Salary Base and Multiplier Used to Calculate Final Average Salary (FAS)**

A policy that increases pension costs in many defined benefit plans is the spiking of salaries in the years prior to retirement used to calculate final average salary (FAS). States have addressed this problem in several ways.

Some states have increased the number of years used to calculate FAS. In New Jersey, Louisiana, Iowa, and Arizona the FAS is now calculated over 5 years rather than 3 years, and in Illinois it is calculated over 8 years.

Some states have reduced the multiplier used to calculate benefits based on years of service. Louisiana, for example, reduced the multiplier for all non-hazardous employees to 2.5%, and to 3.33% for hazardous duty employees.

The actuarial benefit formula for KPERS members is FAS x Years of Service x Statutory Multiplier.¹⁸ There are separate statutory multipliers for different groups of retirees and other multipliers applicable to certain service credits. The calculation of FAS varies based upon each member's hire date. See Appendix 2 for the methodology of calculating FAS and for sample benefit calculations.

A few states have imposed caps on the maximum amount of benefits that retirees can receive in defined benefit plans. Illinois, for example, decreased the maximum benefit for members of the General Assembly and judges from 85% of FAS to 60% of FAS.

Some states have also restricted or eliminated the ability of employees to purchase years of service toward their retirement benefit. This policy adds to pension costs to the extent that the service credits are subsidized by the state.

Kansas continues to allow KPERS members to purchase service credit.

Modifying benefits for new hires in recent years has passed judicial muster. However, modifying benefits for current employees and retirees has been challenged in the courts. In Colorado a group of retirees has filed a lawsuit challenging the reduction in the cost of living adjustment for benefits received by retirees. Their lawsuit maintains that pension benefits for current employees and retirees is protected by the U.S. and Colorado Constitutions. An earlier opinion by the Attorney General in Colorado stated that reforms of the Colorado pension plan are justified if they are necessary for the solvency of the retirement system. It remains to be seen how the courts will rule on the recent lawsuits.¹⁹

Conclusion

The actuarial analysis conducted for Utah was an important impetus for reform of the pension plan in that state. Legislators concluded that even if the assumed 7.75 percent rate of return on assets was met, the cost of their defined benefit plan was prohibitive. More importantly they were not willing to expose the state to the risk associated with unfunded liabilities in the defined benefit plan. As state Senator Dan Liljenquist, who sponsored the Utah legislation reforming the pension plan, stated after the Senate vote, "there is only one thing that could bankrupt this state, and that is an unfunded liability that comes from our pension program".²⁰

Solving the problem of unfunded liabilities in the state pension plan will be a more formidable task in Kansas, and one that is therefore more urgent. Kansas' public employee retirement system is already in a funding crisis and the funded status of the Kansas plan is much worse than that in Utah and most states. Based on the market value of plan assets, unfunded liabilities in the KPERS plan are estimated at \$9.3 billion compared to \$6.5 billion in Utah. The funded ratio in KPERS is 56% compared to 97% in the Utah pension plan. The school portion of the KPERS plan is not projected to pay off unfunded liabilities within the amortization period. Kansas must enact pension reform quickly to ensure the future viability of the system and to prevent catastrophic funding shortfalls in the near future.

¹⁸ KPERS Power Point presentation to Senate Select Committee on KPERS, February 3, 2011.

¹⁹ Barry W. Poulson, 'What Now for PERA: Déjà vu All Over Again,' Independence Institute IP-2, March, 2009.

²⁰ Dan Liljenquist, State Senator Utah, 'Remarks to the States and Nation Policy Summit,' American Legislative Exchange Council, Washington D.C., December 2010.

Actuaries have not estimated the contribution rates that would be required to eliminate the unfunded liabilities in the Kansas pension plan. However, given the magnitude of unfunded liabilities in KPERS, the employer contribution rates that would be required to meet these pension obligations is certainly higher than that estimated for Utah. Such an increase in employer contributions into the pension plan are far beyond that provided for in current law which limits such increases to .6% per year. The economic consequences of meeting the future cost of the existing defined benefit plan would be severe, as the state would have to significantly raise taxes or cut other government programs.

Solving the KPERS funding crisis will be challenging and not without controversy, but it must be done. Fortunately, there is a considerable menu of proven options from which legislators and taxpayers can choose to create the Kansas Plan.

Appendix 1 — Why the Funding Crisis in State Pension Plans May Be Worse When Evaluated by Private Pension Plan Requirements

A recent study by the National Bureau of Economic Research (NBER) suggests that the funding status in public pension funds is worse than reported.²¹ These pension systems are likely to experience significant funding shortfalls in future years, even if the economy recovers and financial markets stabilize. These funding shortfalls will impose a heavy burden on future generations.

The potential for future funding shortfalls in pension plans can be estimated from future assets and future liabilities. Future liabilities are estimated based on the current actuarial value of liabilities, the discount rate employed by the plan, and the amortization period. Future assets are estimated based on the expected growth rate and volatility of the plan's assets.

The NBER study of a sample of state pension plans finds that future under-funding in these plans is actually greater than that reported in their financial statements because of the accounting rules used to estimate future assets and future liabilities in the system.

The NBER study, and other studies as well, point out that the eight percent average discount rate used by these state pension systems is almost certainly too high. This discount rate assumption is based on Government Accounting Standards Board (GASB) ruling 25 and Actuarial Standards of Practice (ASOP) item 27. These standards require a discount rate determined by the accrued return on pension plan assets. Critics argue that the discount rate should be based on the market risk inherent in the system liabilities.²²

Support for the critics' position comes from the discount rate used in private pension plans. In contrast to government pension plans, private pension plans use a discount rate applied to liabilities that is a blend of corporate bond yields and Treasury bond yields. The NBER study uses a lower discount rate to estimate the present value of future liabilities in their sample of state pension systems. In 2005, the present value of liabilities in these state plans—based on an eight percent discount rate—is estimated at \$2.5 trillion. Using the Municipal bond rate to determine the discount rate results in an estimated present value of liabilities equal to \$3.1 trillion; using the Treasury rate as the discount rate, the present value of the liabilities is estimated at \$4.0 trillion.²³

The use of lower discount rates to estimate the present value of future liabilities results in much higher estimates of unfunded liabilities in these state pension plans. In their financial statements, these public pension plans estimate unfunded liabilities at \$312 billion. The NBER study estimates unfunded liabilities at \$901 billion using the Municipal bond discount rate

²¹ Robert Novy-Marx and Joshua D. Rauh, 'The Intergenerational Transfer of Public Pension Promises,' Working Paper 14343, National Bureau of Economic Research, Cambridge, MA, September, 2008.

²² Novy-Marx, Robert, and Joshua D. Rauh 'The Intergenerational Transfer of Public Pension Promises,' Working Paper 14343, National Bureau of Economic Research, Cambridge, MA, September, 2008; Barclays Global Investors, 'The Retirement Benefit Crises: A Survival Guide,' Barclays Global Investors Investments Insights 7(5), 2004; Jeremy Gold, 'Risk Transfer in Public Pension Plans,' Wharton Pension Research Council Working Paper 2002-18, 2002; Lawrence N. Bader and Jeremy Gold 'The Case Against Stock in Public Pension Funds,' Pension Research Council Working Paper, 2004.

²³ Robert Novy-Marx and Joshua D. Rauh, 'The Intergenerational Transfer of Public Pension Promises,' Working Paper 14343, National Bureau of Economic Research, Cambridge, MA, September, 2008.

and \$1.9 trillion using the U.S. Treasury discount rate. Unfunded liabilities as a ratio of assets in the plans is estimated at 41 percent and 86 percent, respectively, for these lower discount rates.²⁴

One way to assess the magnitude of the funding crises in state pension plans is to use the same government standards as those applied to private defined benefit pension plans. Private defined benefit pension plans are considered 'safe' by government standards if they have enough assets to support at least 80 percent of pension benefit obligations. In 2008, only nine percent of a sample of state and local government pension plans met this standard.²⁵

Private defined benefit pension plans are considered 'critical' if the value of assets in the plan is 65 percent or less of pension benefit obligations. This year more than half of state and local government pension plans are likely to fall in this 'critical' category.²⁶ Using market values for portfolio assets, the KPERS systems falls into this critical category.

The most important finding in the NBER study is the prospect of future under-funding in state pension plans based on more realistic discount rates. Using a 15-year amortization period, the NBER study estimates, conservatively, that there is a 50 percent chance of under funding greater than \$750 billion; a 25 percent chance of under-funding greater than \$1.75 trillion; and a 10 percent chance that under-funding will exceed \$2.48 trillion. These estimates do not include any under-funding in other post employment benefit (OPEB) plans in these state pension systems.²⁷

²⁴ Robert Novy-Marx and Joshua D. Rauh, 'The Intergenerational Transfer of Public Pension Promises,' Working Paper 14343, National Bureau of Economic Research, Cambridge, MA, September, 2008.

²⁵ A.H. Munnell, J. Aubrey, and D. Muldoon, 'The Financial Crises and State/Local Defined Benefit Plans', Center for Retirement Research, Number 8-19, November, 2008.

²⁶ A.H. Munnell, J. Aubrey, and D. Muldoon, 'The Financial Crises and State/Local Defined Benefit Plans', Center for Retirement Research, Number 8-19, November, 2008.

²⁷ Robert Novy-Marx and Joshua D. Rauh, 'The Intergenerational Transfer of Public Pension Promises,' Working Paper 14343, National Bureau of Economic Research, Cambridge, MA, September, 2008.

Appendix 2 — Sample KPERS Benefit Calculations

The following estimates are shown by way of example only and should not be used to calculate actual retirement benefits. There are many nuances applicable to the three defined benefit plans operated by KPERS (Kansas Public Employees Retirement System, Kansas Police & Firemen's Retirement System and Kansas Retirement System for Judges) regarding hire dates, length of service and other factors. Benefits are calculated differently for Tier 1 members (hired prior to July 1, 2009) and Tier 2 members (those hired after July 1, 2009). These sample benefit calculations only pertain to Tier 1 members. Members must also meet certain minimum age requirements and minimum service requirements to qualify for unreduced benefits; these sample benefit calculations also assume that retirees meet these requirements and retire at age 65.

Generally speaking, the formula for calculating KPERS benefits is Final Average Salary (FAS) x Years of Service x Statutory Multiplier. For Tier 1 members hired on or after July 1, 1993, FAS is the average of their three highest years, excluding additional compensation, such as sick and annual leave. For Tier 1 members who were hired before July 1, 1993, FAS is the greater of either (a) four-year FAS including additional compensation, such as sick and annual leave; or (b) three-year FAS excluding additional compensation, such as sick and annual leave.²⁸

Retirees can elect to have a portion of their pension continue to a surviving spouse and/or take a one-time partial lump sum distribution, both of which result in reduced regular benefits. These sample calculations assume that neither option is elected.

Table 11. Sample KPERS Benefit Calculations

	KPERS Tier 1		KP&F		Judge	
	Ex. 1	Ex. 2	Ex. 1	Ex. 2	Ex. 1	Ex. 2
FAS	\$50,000	\$50,000	\$50,000	\$50,000	\$50,000	\$50,000
Years of Service	30	35	25	32	15	20
Multiplier	1.75%	1.75%	2.50%	2.50%	3.50%	3.50%
Annual Pension	\$26,250	\$30,625	\$31,250	\$40,000	\$26,250	\$35,000
Pension % of FAS	53%	61%	63%	80%	53%	70%

Note: The maximum service credit for KP&F retirees is 32 years. Judges with service prior to July 1, 1987 can receive up to ten years' service credit at a 5% multiplier; the calculation in Example 2 is based on 20 years' service at 3.5% and no years' service at 5%. Judges receive a maximum service credit of 20 years at the 3.5% multiplier; regardless, the maximum pension allowed is 70% of FAS. There is no maximum years of service or maximum pension % of FAS for other KPERS retirees.

²⁸ KPERS Comprehensive Annual Financial Report, fiscal year ended June 30, 2010, page 93.

Table 12. Retirement Benefit Estimates for 2010*(millions of dollars)*

Total KPERS distributions - Calendar 2010	\$1,108.6
Estimated portion from Employers	75%
Estimated Employer funds distributed	\$831.5
Assumed state income tax rate (middle bracket)	6.25%
Estimated state income tax benefit to KPERS retirees	\$52.0

Source: KPERS 2010 distributions as listed at www.KansasOpenGov.org in the Retiree section; Kansas Dept. of Revenue

KPERS Retirement Benefit Estimates²⁹

KPERS retirement benefits are considerably more generous than those received by most private sector employees. Not all private sector employees receive retirement benefits from their employers and most of those who do are enrolled in 401(k) plans, where the employer contribution generally is between 1% and 10% of employee earnings.

Employer contributions required to fully fund the plans based on the market value of assets for KPERS members is currently between 15% and 20%, and those rates are predicted to rise even higher if major reforms are not enacted soon.

KPERS retirees also receive preferential tax treatment. Unlike private sector retirement plans, KPERS benefits are not taxable for state income tax purposes. Employee contributions to the plan are after tax, so it's appropriate that distributions from employee contributions would be not be taxable to avoid double taxation. However, KPERS members never have to pay state income tax on the majority of their pension benefits, which come from employer contributions and earnings on employer contributions.

The cost to taxpayers of providing government retirees with these tax-free benefits is substantial. The exact amount of pension distributions from employer contributions and the applicable tax rate for each recipient would have to be identified to accurately calculate the benefit, but we can make a reasonable estimate. As noted in Table 4, in order to fully fund the state/school plan based on the market value of plan assets, the employer contribution rate would be 15.26% and the total employer and employee contribution rate would be 19.33%; the employer rate is therefore 78.9% of the total. For the KP&F plan, the employer rate would be 75% of the total (19.8% for the employer, 26.32% in total). The following estimate of a \$52 million income tax benefit to KPERS retirees is based on the lower employer rate of 75%.

Most KPERS retirees are also eligible for Social Security benefits. According to KPERS Executive Director Glenn Deck:

"All KPERS and Judges plan members are eligible for Social Security and they and their employers contribute to Social Security coverage. Because Social Security has different eligibility ages and taxation incentives, a KPERS retiree might be drawing KPERS benefits and has not yet applied to draw Social Security benefits. A large number of KP&F members are not eligible for Social Security by virtue of their law enforcement or firefighter employment. Their employers opted out of Social Security coverage for those positions years ago. Those employees and their employers do not contribute to Social Security for their law enforcement or firefighter position. Those individuals could potentially gain Social Security coverage on any outside employment, but it would not be based on their governmental compensation and there are some Social Security limitations to these benefits called the Governmental Pension Offset (GPO)."³⁰

²⁹ Calculations prepared using benefits estimator on KPERS web site at <http://www.kpers.org/benefitestimate.htm>, accessed February 26, 2011.

³⁰ E-mail received from Glenn Deck on February 27, 2011.

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Testimony supporting HB 2311
By Karl Peterjohn, 3rd district Sedgwick county commissioner
March 7, 2011

My testimony in support of HB 2311 is strictly my own and does not represent any other group or entity. I am sorry that my schedule prevents me from attending your March 7 meeting.

KPERS is in trouble. The recently released Pew Center for the States study ("The Trillion \$ Gap, under funded state retirement systems and the needs to reform"), indicates that KPERS has one of the poorest records of performance as well as funding liability (\$8.3 billion) among all 50 states retirement and pension systems. Only Illinois has a worst record on pension liability according to Pew's study (www.pewcenteronthestates.org/report_detail.aspx?id=56695).

In 2009, when I became a county commissioner in Sedgwick County, I joined KPERS. I realized that KPERS had some problems, but it was not clear to me how severe and significant these problems have become in the last decade. At that time, I wish that more options would have been made available. I continue to believe that government employees need to have a financially sound retirement system to protect them. This 2010 Pew study indicates that KPERS has significantly deteriorated in the last decade that comparable data has been available.

Pew says, "The state has failed to meet actuarially required contributions during the past 10 years, funding less than 80 percent annually." I wish that I had known this in 2009.

Prior to becoming an elected official I had been a contributor and participant in several defined contribution retirement plans. This occurred under several different employers that I had participated in since the 1980's when I joined my first defined contribution plan as an employee of NCR Corporation. By contributing tax deferred funds from my own income as well as receiving significant employer contributions to my 401k accounts, I now have a significant nest egg that will help protect my family and myself in the future.

I will certainly admit that managing this account in the challenging financial times since I joined the county commission in 2009 has not been easy. It is hard. In fact, it is very hard. However, it does make me focus upon the public policy decisions being made by all levels of U.S. government that may, and in my opinion, often have negatively impacted the economy in this country since January, 2009. If I had not wanted to manage this fund actively, I also have the option of turning this family IRA retirement fund over to the mutual fund where my account is being held. There are numerous market index funds that would match the SP 500, Dow Jones, or other widely used market indexes that are available have historically outperformed KPERS.

My experience indicates that government managed funds are often quite troubled, like KPERS is today in Kansas, as well as in a number of other states. In the long run and in these challenging financial times, a well funded defined contribution plan with numerous mutual fund options, is more likely to protect government employees' retirement than our struggling KPERS system.

House Pensions & Benefits

Date: 3/7/2011

Attachment # 3

1559 Payne
Wichita, Kansas 67203
(316) 312-7335 cell
john@johnntodd.net

March 6, 2011

Representative Mitch Holmes, Chair
Committee on Pension and Benefits
Statehouse
Topeka, Kansas

Subject: Written testimony submitted to the Committee on Pension and Benefits for the 9:00 a.m. public hearing on March 7, 2011 in support of House Bill No. 2311

Representative Mitch Holmes, and members of the House Pension and Benefits Committee:

As a private citizen I have been following the news relating to the unfunded actuarial liability (\$7.7 Billion Dollars per the 2010 online financial report) financial crises the KPERS, Kansas Public Employees Retirement System faces, and I support responsible legislation that would to put the system back on an actuarially sound and sustainable basis.

KPERS reform must start immediately, and it strikes me that HB# 2311 is the start the system needs to plug the holes that have been caused by retirement benefits "double-dipping" by public employees.

If the current KPERS system is beyond reform, and/or the painful decision cannot be made within the current system, then the whole program needs to be turned over to private sector companies who understand actuarial tables and who are free of the political pressures that have placed KPERS on a sure course towards bankruptcy.

Sincerely,

John R. Todd

House Pensions & Benefits

Date: 3/7/2004

Attachment # 4



Prepared Testimony in
Opposition to HB 2311

**Before the House Pensions and Benefits Committee
Kansas House of Representatives**

March 7, 2011

Terry Forsyth
Coalition for Keeping the Kansas Promise
www.keepingthekansaspromise.com

Chairman Holmes and Members of the House Pensions and Benefits Committee:

House Bill 2311 represents a direct threat to the retirement security of both current KPERS members and KPERS retirees, and to the long-term financial security of Kansas taxpayers.

Fundamentally, our shared goal in the 2011 legislative session has been to address the KPERS unfunded actuarial liability (hereinafter "UAL") with the intention of preserving the retirement security for Kansas public employees and KPERS retirees meanwhile being ever mindful of the Kansas taxpayer in reaching a solution for resolving the KPERS UAL. *House Bill 2311 misses that target.*

Substantial credible and persuasive testimony received by the House Pensions and Benefits Committee this legislative session has accurately classified any attempt to shift from the current KPERS defined benefit plan to a defined contribution plan as a procedure to "cripple the defined benefit system" of which 280,000 Kansas public employees and public employee retirees rely for their retirement security.

The current defined benefit plan offered by the KPERS system is the superior method of ensuring (i) short- and long-term retirement security for Kansas public employees and public employee retirees and (ii) protecting Kansas taxpayers from bearing the full obligation for financing public employee retirements. Consider that:

Testimony in Opposition to HB 2311 (2011)
House Pensions & Benefits Committee
March 7, 2011

House Pensions & Benefits

Date: 3/7/2011

Attachment # 5

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

It is the position of the Coalition for Keeping the Kansas Promise and Coalition partners that shifting KPERS from a defined benefit system, even if for future public employees, does not eradicate the unfunded actuarial liability of the KPERS fund. In fact, the creation of a defined contribution plan for KPERS, which will remove revenues used to reduce the unfunded actuarial liability, will only accelerate the insolvency of the KPERS fund for current KPERS members and retirees from FY 2033 to an uncertain, though more immediate, date in the future, and place the entire KPERS funding obligation upon Kansas taxpayers. Moreover, we would encourage members of the Committee to consider that the KPERS defined benefit plan offers Kansas policymakers incredible flexibility in managing a large public employee workforce, which cannot be offered by any defined contribution plan without considerable increased cost.

It is our shared goal to obtain a solution for resolving the KPERS UAL. However, all persuasive and credible testimony points reach the same conclusion regarding the House Bill 2311 defined contribution system: the legislation does nothing to resolve the existing KPERS UAL.

(For the ease of members of the Committee, all resources cited within today's expanded testimony have been made available on the *Coalition for Keeping the Kansas Promise* website at <http://www.keepingthekansaspromise.com/legislation/2311-2011>.

I. Defined Benefit Plans are Less Costly Than Defined Contribution Plans for Taxpayers and Retirees in the Short- and Long-Term.

A. Defined Benefit System Plans Require Substantially Less Employer Contributions Than Defined Contribution Plans and, Therefore, Reduce the Obligation of Kansas Taxpayers.

Defined benefit plans, on a national average, require contributions equal to 12.5 percent (%) of payroll.¹ In FY 2010, all group average contributions towards the KPERS fund equaled 12.2 percent (%), making Kansas' defined benefit plan statutory contributions as a percent of total payroll less than the national average.²

Defined contribution plans, however, require contributions to be nearly twice the contribution of defined benefit plans, with 22.9 percent (%) of payroll required.³ The significant cause for increased contributions under defined contribution pension plans is that there are no longer pooled investments and, therefore, investment earnings to supplement employer and employee contributions. Over the last 25 years, on a national average, pooled investment earnings from defined benefit pension plans have funded more than two-thirds of public employee retirement benefits.⁴

In 1991, the West Virginia General Assembly created the Teachers' Defined Contribution System. However, 14 short years later, the Assembly created the Teacher's Defined Benefit Retirement Plan. According to the West Virginia Consolidated Retirement Board's actuary, the change would save the West Virginia \$1.8 billion over the next 30 years, because of lower employer contributions required for the defined benefit plan (4.3 percent of payroll) than for the defined contribution plan (7.5 percent of payroll). Upon member election, 78 percent (%) of the 1991 defined contribution system members subsequently joined the 2005 defined benefit system. It was more affordable for West Virginia taxpayers and it helped to

¹ A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans, Beth Alemeida and William B. Forna, FSA, National Institute on Retirement Security, 14 (available online at <http://www.scribd.com/doc/50173811>).

² 2010 Comprehensive Annual Financial Report, Kansas Public Employees Retirement System, 40 (Nov. 12, 2010) (available at <http://www.kpers.org/annualreport2010.pdf>) (FY 2010 Average Contributions as a Percent of Total Payroll Per Group Equaled 12.6% for the State Group; 12.2% for the School Group; 10.4% for the Local Group; 22.0% for the KP&F Group; and 26.1% for Judges Group.).

³ FNI.

⁴ NCPERS Research Series: The Top 10 Advantages of Maintaining Defined Benefit Plans, National Council of Public Employee Retirement Systems, at 2 (Jan. 2011) (available at <http://www.scribd.com/doc/50173811>).

attract and retain West Virginia high quality public employees.⁵

In real dollars, over the career of an average employee who retires at age 62, a defined benefit plan requires, on a national average, roughly \$355,000 for each employee where as, also on a national average, a defined contribution system plan requires approximately \$550,000 to be set aside for each employee – an additional \$194,000 more in total lifetime contributions than a defined benefit system.⁶

The KPERS consulting actuary, Ms. Patrice Beckham of Cavanaugh MacDonald Consultants, LLC, advised during the January 24, 2011 House Pensions and Benefits Committee that, under the current KPERS defined benefit plan, the state's statutory contributions as a percent of total payroll for the KPERS school group – the most underfunded of each of the KPERS groups – would not exceed the level of 22.9 percent (%) until FY 2034 under the current statutory funding contribution cap limitations.⁷

The current KPERS defined benefit plan system provides the best opportunity for Kansas public employees, public employees and taxpayers for limiting the growth of necessary contributions, and the defined contribution plan proposed by House Bill 2311 will require nearly double the investment as the current defined benefit system.

B. State and Local Government Exemption from the ERISA PBGC Tax Creates a Competitive Advantage Over Private Industry When Offering a Defined Benefit Pension Plan.

While it is often recited with mantra-like qualities that private industry is shifting its retirement plans away from defined benefit plans and instead opting in favor of defined contribution plans, *the cause of this shift is not often accurately portrayed.*

Congress' 1975 adoption of the Employee Retirement Income Security Act (ERISA) has caused the shift by private market employers from the defined benefit to defined contribution plan not because of investment and plan inefficiencies, but instead because of the Pension Benefit Guaranty Corporation (PBGC) tax that is applicable to only to private industry

⁵ "Pension bond will benefit taxpayers: The state will save \$24 million first year alone," Charleston Daily Mail, Editorial, Page P4A (June 14, 2005) (available at <http://www.scribd.com/doc/50173820>).

⁶ FN1 at 14.

⁷ Presentation to the House Pensions and Benefits Committee: Actuarial Principles and Funding, Patrice A. Beckham, KPERS Consulting Actuary, Cavanaugh MacDonald Consultants, LLC, at 53 (Jan. 24, 2011) (available at <http://www.scribd.com/doc/50025387>).

defined benefit plans. State and local defined benefit plans are exempt from the ERISA PBGC tax.⁸

Ms. Beckham further discussed this significant difference between private and public sector defined benefit plans during her January 24, 2011 appearance before this Committee, advising committee members to not “compare the public pension program with a private pension program,” because “*it’s not apples-to-apples.*”⁹

C. Defined Benefit Plans Offer Longevity Risk Pooling Unavailable in Defined Contribution Plans and, Therefore, Produce Superior Returns at Less Cost Over Defined Contribution Plans.

Defined benefit plans offer longevity risk pooling by averaging risks over a large number of participants and lower asset and plan management fees that cannot be offered by defined contribution plans.

Defined benefit plans lower the total costs of providing retirement benefits. Instead of requiring contributions that are large enough to fund retirement benefits through maximum life expectancy, as required by defined contribution plans, defined benefit plans only need to fund benefits through the average life expectancy of the group. This lowers contributions required of Kansas public employees and Kansas taxpayers alike. Moreover, by spreading investment risk over a longer period, defined benefit plans can maintain an investment mix that includes a higher percentage of equity investments, thus increasing investment returns and further lowering required employer and employee contributions.

Also, defined benefit investment earnings supplement employer and employee contributions. Over the past 25 years, the pooled investments offered exclusively by defined benefit plans have produced more than two-thirds of public retirement benefits nationally.¹⁴ Pooled investments are unavailable within defined contribution systems.

⁸ White Paper: Myths and Misperceptions of Defined Benefit and Defined Contribution Systems, National Association of State Retirement Administrators, at 2-3 (Nov. 2002, rev. Feb. 2005) (available at <http://www.scribd.com/doc/50173827>).

⁹ House Pensions & Benefits: KPERS Actuary lays factual foundation for 2011 legislative session, January 24, 2011 (available at <http://www.keepingthekansaspromise.com/ksleg/1-24-2011-committee/>).

¹⁴ NCPERS Research Series: The Top 10 Advantages of Maintaining Defined Benefit Plans at 2 (available at <http://www.scribd.com/doc/50173811>).

Additionally, the KPERS-managed defined benefit plan centralizes professional plan and asset management creating efficiencies that cannot be obtained through a defined contribution plan where investment and plan management are decentralized among hundreds, if not thousands, of plan and asset managers. Should House Bill 2311 become law, the KPERS and KPERS members would be required to manage another plan in addition to the existing defined benefit plan, which, in FY 2010, cost more than \$32 million to manage.¹⁵

Finally, there is an extraordinary cost associated with shifting new members to a defined contribution system. For example, the budget for the state of Florida's switch to a defined contribution plan for public employees in 2000 totaled \$89 million from FY 2001 to FY 2004, including \$55 million to educate Florida's public employees about the new plan.¹⁶

D. The Security Offered by Defined Benefit Plans Assure a Source of Retirement Income for Retirees, Reducing the Likelihood of Retirees Relying on Public Assistance During Retirement.

Kansans, not unlike other Americans, are living longer. The KPERS defined benefit plan provides a modest, though guaranteed, retirement benefit for retirees from the time of retirement until their deaths, regardless of their age at time of death – a feature unavailable within the defined contribution system proposed by House Bill 2311. The defined contribution plan proposed by HB 2311 would require participants to contribute and save enough to ensure they will not outlive their benefits while protecting their funds against under-contribution and under-performance.

In 2005, the average American life expectancy at age 65 was 16 years for men (age 81) and 19 years for women (age 84) (2005);¹⁷ and 71,000 people were 100 years of age or older in, and 1.9 million Americans were 85 or older.¹⁸ This means that defined contribution plan participants must contribute enough to ensure their benefits will be paid through their maximum life expectancy, i.e., at least until their late 90s.¹⁹

¹⁵ 2010 Comprehensive Annual Financial Report, Kansas Public Employees Retirement System, 49 (Nov. 12, 2010) (available at <http://www.kpers.org/annualreport2010.pdf>).

¹⁶ Traditional Defined Benefit Pension Plans: A Tried and True System That Benefits Taxpayers, National Conference of Public Employee Retirement Systems (NCPERS) at 9 (available at <http://www.scribd.com/doc/50173806>).

¹⁷ Traditional Defined Benefit Pension Plans: A Tried and True System That Benefits Taxpayers at 14 (available at <http://www.scribd.com/full/50173806>).

¹⁸ *Id.*

¹⁹ *Id.*

The defined contribution plan proposed by HB 2311 lacks the inherent quality of longevity risk pooling available under the KPERS defined benefit plan. A switch from the KPERS defined benefit plan to a defined contribution plan will inevitably leave those Kansas retirees that are fortunate to enjoy long lives with benefits exhausted and in the unfortunate situation of relying upon public assistance provided by Kansas taxpayers.

II. **Shifting the Kansas Public Employee Retirement System From a Defined Benefit to a Defined Contribution System Does Not Eradicate the Unfunded Actuarial Liability. In Fact, It Only Accelerates Insolvency of the KPERS Fund for Current KPERS Members and Retirees, Placing the Entire KPERS Funding Obligation Upon Kansas Taxpayers.**

During the January 24, 2011 House Pensions and Benefits Committee, in response to questioning from Committee members regarding how to accomplish a shift from the current KPERS defined benefit plan to a defined contribution system, Ms. Beckham, the KPERS consulting actuary, responded: "*You will cripple the defined benefit plan.*"²⁰

Ms. Beckham's presentation on January 24, 2011 to this Committee explained the *basic retirement funding equation*:²¹

$$\text{Contributions (C) + Investments (I) = Benefits Paid (B) + Expenses (E)}$$

A shift to a defined contribution pension plan for Kansas' public employees would fundamentally alter the *basic retirement funding equation*. Namely:

- **Contributions (C)** allocated to the current defined benefit pension plan would decrease and would continue to substantially reduce as the current Tier I and Tier II employees retired and ceased making contributions to the system;
- **Investments (I)** would decrease, placing the entire obligation upon the Kansas taxpayer to fund retirement pensions *and* resolve the unfunded actuarial liability;

²⁰ House Pensions & Benefits: KPERS Actuary creates factual foundation for 2011 legislative session, January 24, 2011 (available online at <http://www.keepingthekansaspromise.com/ksleg/1-24-2011-committee/>).

²¹ Presentation to the House Pensions and Benefits Committee: Actuarial Principles and Funding, Patrice A. Beckham, KPERS Consulting Actuary, Cavanaugh MacDonald Consultants, LLC, at 5 (Jan. 24, 2011) (available at <http://www.scribd.com/doc/50025387>).

- **Expenses (E)** would increase as the now centralized and efficient asset and plan management of KPERS is decentralized to hundreds of investment and plan managers; and
- **Benefits Paid (B)** would not, however, reduce for those members currently under the defined benefit plan, which cannot be legally reduced or dissolved, because, as a general principle, benefits that have already been earned by KPERS covered public employees and retirees cannot be reduced, amended nor eliminated.²²

The creation of a defined contribution plan within the KPERS system, even if limited to just new state employees, creates untenable mathematics of decreasing contributions and investments; increasing total benefits paid out for a retiring generations of current KPERS defined benefit plan participant; and increases in the total cost of expenses with an already burgeoning \$7.7 billion unfunded actuarial liability. Meanwhile, benefits will remain constant. This is a mathematical equation that defies reality with a result that causes the acceleration of KPERS insolvency from a manageable benchmark of FY 2033 to an unmanageable and currently unknown date in the immediate future.

Quite simply, any switch from the current KPERS defined benefit plan to a defined contribution plan is a recipe for financial disaster for public employees, public employee retirees and, Kansas taxpayers who will be left to pay for the legally obligated retirements of generations of Kansas public employees without the assistance of investment earnings from the pooled investments of the defined benefit plan. This is particularly true when considering that defined benefit investment earnings supplement employer contributions, which, on a national average, have funded more than two-thirds of public retirement benefits over the past 25 years.²³

²² See, generally, Singer v. City of Topeka, 227 Kan. 356, 363 (1980) ("A public employee, who over a period of years contributes a portion of his or her salary to a retirement fund created by legislative enactment, who has membership in the plan, and who performs substantial services for the employer, acquires a right or interest in the plan which cannot be whisked away by the stroke of legislative or executive pen, whether the employee's contribution is voluntary or mandatory."); and Shapiro v. Kansas Public Employees Retirement System, 216 Kan. 353, Syl. ¶1 (1975) ("State retirement systems create contracts between the state and its employees who are members of the system.")

²³ NCPERS Research Series: The Top 10 Advantages of Maintaining Defined Benefit Plans at 2 (available at <http://www.scribd.com/doc/50173811>).

III. **The KPERS Defined Benefit Plan Provides Kansas Policymakers with Extraordinary Flexibility to Manage a Large Public Employee Workforce in an Environment of Shifting Policy Goals.**

A. **Defined Benefit Systems Offer an Effective Incentive for Recruiting and Retaining Quality Employees.**

The promise of a guaranteed retirement pension with a higher average retirement benefit provided by traditional private market retirement plans, such as the defined contribution plan, is an attractive incentive for recruiting and retaining quality employees.

Multiple studies and sources have similarly concluded that, in Kansas, public employees earn \$3,300 to \$12,000 less annually than private market counterparts possessing equal education and experience with similar job position responsibilities.^{24 25} The KPERS defined benefit plan offers an effective incentive for the state of Kansas in recruiting and retaining quality employees in a highly competitive marketplace for trained, educated, and experienced employees.

A switch to a defined contribution plan will limit the ability of the state of Kansas to attract and retain skilled, educated and experienced individuals to fill state jobs and, moreover, will exacerbate labor shortages in key service areas, such as teachers, corrections officers, and direct care staff in state hospitals, by increasing employee turnover. Higher turnover rates, in turn, lead to an increase in training costs and lower levels of productivity, possibly resulting in the need for a larger state workforce.

In 1977, the North Dakota Public Employees Retirement System, originally established as a defined contribution plan in 1966, was amended to a defined benefit plan. Among the reasons cited for the change included the need to attract and retain quality employees.²⁶

²⁴ "Wisconsin one of 41 states where public employees earn more," by Dennis Cauchon, *USA Today* March 1, 2011 (available at <http://www.scribd.com/doc/50173838>) (ranking Kansas 49th nationally for public employee pay and illustrating that public employees in Kansas, on average, make \$3,229 less than private market counterparts).

²⁵ *State of Kansas: Salary Survey Report, The Hay Group*, January 2007 (report commissioned by the Kansas Legislature, finding that Kansas public employees make, on average, 25 percent less than private market counterparts) (available online at <http://www.scribd.com/doc/50173819>).

²⁶ *Public Employees Retirement Programs – History*, North Dakota Legislative Council, Employee Benefits Program Committee (Oct. 1998).

Ensuring that the state of Kansas is hiring and retaining the most highly skilled employees is of extraordinary benefit for Kansas policymakers taxpayers and ensures that taxpayers are receiving the 'biggest bang' for the tax dollar 'buck.'

B. Defined Benefit Plans Encourage Retirement of Older Employees Whose Efficiency, Effectiveness and/or Productivity May Have Decreased.

Through offering a guaranteed and modest retirement benefit that offers enhanced retirement benefit and security than the benefits offered by defined contribution plans, defined benefit plans encourage older workers to retire earlier. Defined contribution plans, which do not offer a guaranteed pension throughout retirement and offer a lower monthly retirement benefit, in fact, offer a disincentive for older workers to retire. A defined contribution system will encourage older employees who may not be as efficient, effective or productive to remain in state employment.²⁷

The KPERS defined benefit plan offers Kansas policymakers the necessary flexibility to encourage longer service for key classified employees. Benefit formulas can be structured to provide incentives for longer employment by increasing the benefit multiplier after a certain period of service. Other flexibilities to encourage retirement include deferred retirement option plans (DROPs) that credit employees in a separate retirement account who continue to work after retirement eligibility.²⁸ Switching to a DC plan would limit this flexibility and make these incentives more expensive for the state of Kansas and, ultimately, Kansas taxpayers.

The state of Kansas and Kansas Legislature currently have incredible flexibility in an environment of shifting policy goals to encourage or discourage – as the situation demands – longer service of employees under the present KPERS defined benefit plan. A switch to the defined contribution system will reduce the flexibility of state government to manage a large public employee workforce, an incredibly important asset to possess during times of crisis and economic turbidity.

IV. Conclusions.

The pooled investments of the KPERS defined contribution plan provides financial security for Kansas public employees, Kansas public employee retirees and Kansas taxpayers. A shift

²⁷ White Paper: Myths and Misperceptions of Defined Benefit and Defined Contribution Systems at 2-3 (available at <http://www.scribd.com/doc/50173827>).

²⁸ Traditional Defined Benefit Pension Plans: A Tried and True System That Benefits Taxpayers at 13 (available at <http://www.scribd.com/doc/50173806>).

to any defined contribution plan would significantly weaken the retirement security of 280,000 current Kansas public employees and public employee retirees, and place Kansas taxpayers in extraordinary financial risk of assuming the full financial obligation of funding the unfunded actuarial liability of the KPERS fund. Moreover, a the KPERS defined benefit plan provides Kansas policymakers with incredible flexibility in managing a large public sector workforce – a flexibility not available under any defined contribution plan without great added expense.

The Coalition for Keeping the Promise and its coalition partners would urge the House Pensions and Benefits Committee to reject House Bill 2311 as a risky experiment proven in other states to be an insecure and financially risky plan for providing diminished public employee retirement security.

END

TESTIMONY

BY

THE KANSAS COALITION OF PUBLIC RETIREES

Before the House Pensions, Benefits and Investments Committee

March 7, 2011

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Ron Gardner and I am here today speaking on behalf of the Kansas Coalition of Public Retirees. Our testimony today is based on the interest of all Kansas Public Retirees including the members of the thirty-nine associations that belong to the Coalition. We recognize the fact that something must be done to bring KPERS back into actuarial balance as soon as possible. We choose to concentrate on the issue of preserving the current system. We do not believe that changing the current defined benefit system to a defined contribution system will solve the issue of the unfunded actuarial liability. We do not believe that HB2311 addresses this fundamental issue. Therefore, the Kansas Coalition of Public Retirees opposes HB2311. We realize that efforts to address long-term funding short-fall will be part of an ongoing process.

A positive step was taken with the passage of the KPERS Tier 2 bill in 2007 and implemented July 1, 2009. Now we need to continue to move in a positive manner. The implementation of a new tier does not relieve the responsibility of the legislature to fund Tier 1 and Tier 2 according to the actuary. HB2311 stipulates a 6% contribution from employees and a 3% contribution from the employer. The Kansas Regents defined contribution plan is funded with 5.5% from employees and 8.5% from the employer. The difference in the employers contribution between HB2311 and the Regents plan is totally unacceptable.

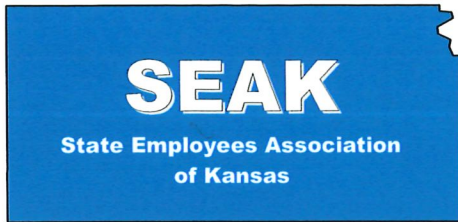
In closing Mr. Chairman, the Kansas Coalition of Public Retirees thanks you and the committee for your time and consideration on this critical issue.

Ron Gardner

House Pensions & Benefits

Date: 3/7/2011

Attachment # 6



P. O. Box 4091
Topeka, KS 66604
(785) 267-1515

March 7, 2011

Representative Mitch Holmes, Chair
House Pensions and Benefits Committee
Room 165-W
State Capitol Building
Topeka, KS 66612

Dear Representative Holmes:

On behalf of the Board of Directors and membership of the State Employees Association of Kansas, I wish to voice my opposition to HB 2311. We feel that action on this bill at this time is premature and not in the best interest of KPERS or its constituents.

Our opposition is based on the following:

- There is currently an unfunded actuarial balance (UAL) for KPERS approaching \$8.0 Billion. Governor Brownback has made it a priority for legislation to address this UAL issue.
- KPERS must rely on three sources to address the UAL: employer contributions; employee contributions; and, investment income. Passage of a defined contribution plan at this time would reduce significantly KPERS income from both employer and employees thus further undermining KPERS' financial condition.
- The State of Kansas, as an employer, short-funded KPERS by approximately \$2.5 Billion. This, in part, is the reason for the UAL. Had the State of Kansas paid its fair share, the income plus investment income would have resulted in a much lesser UAL for the state to face.

While we are in opposition to the bill at this time, it is not to say that our organization would not support a defined contribution at some time in the future when KPERS has reached a point of financial equilibrium.

Sincerely,

A handwritten signature in black ink, appearing to read "G. Adkins", is written over the printed name.

Gary D. Adkins
Executive Director

House Pensions & Benefits

Date: 3/7/2011

Attachment # 7



Prepared Testimony in
Opposition to HB 2333

**Before the House Pensions and Benefits Committee
Kansas House of Representatives**

March 7, 2011

Terry Forsyth
Coalition for Keeping the Kansas Promise
www.keepingthekansaspromise.com

Dear Chairman Holmes and Members of the House Pensions and Benefits Committee thank you for the opportunity to share our concerns regarding HB 2333. I am Terry Forsyth and I represent The Coalition for Keeping the Kansas Promise.

We oppose HB 2333 because the bill:

- creates administrative challenges that could drive up administrative costs,
- makes communications to employees regarding benefits challenging and confusing, and
- creates inequities between active and inactive KPERS members.

As written the bill would be administrative challenge for KPERS. The result of phasing in the change in retirement age would provide a different retirement age calculation for each and every KPERS member as they prepare to retire. Such a change might have the unintended consequence of driving up administrative costs for KPERS.

Each current KPERS active member receives a communication from the system explaining their current calculated retirement benefits and at which age those retirement benefit numbers apply. There is a certain expectation that current active members have as a result of the KPERS update communications that they receive. Continual changes over this period would only serve to make decisions about retirement more challenging.

There also is the problem for inactive KPERS members who expect to receive retirement benefits. It now would take them an additional 10 years to receive those retirement benefits. An active KPERS member receives two points per year of service – one point for service and one for age. Changing from 85 to 95 points, an active member would have to work an additional 5 years. An inactive member would be required to wait an additional 10 years before they could access their retirement benefits.

House Pensions & Benefits

Date: 3/7/2011

Attachment # 8



We would encourage the committee to first consider passage of the recommendations that have been proposed by the KPERS actuary, starting with increasing the cap on contributions from .6% to 1%. This proposal has been debated in this building for several years. Imagine if it had been adopted when first requested; we might be a better position today.

Let's start with what KPERS has asked for and then consider additional strategies for shoring up the system.



House Pensions and Benefits Committee
Rep. Holmes, Chair

H.B. 2333 – adjusting KPERS retirement

Diane Gjerstad
Wichita Public Schools
March 7, 2011

Mr. Chairman and Members of the Committee:

H. B. 2333 would gradually raise the KPERS retirement age over ten years to 95 points through an annual point increase. As a large employer we would like to share with the committee the administrative complexities associated with this proposal.

Wichita Public Schools has approximately 7600 employees in the KPERS annual report. Verification of KPERS tier is required each time an employee is hired, rehired or moved into a KPERS covered position. The recent change to Tier 2 required reprogramming of the district human resource system and procedural changes to differentiate the calculations for contributions and benefits payments. H.B. 2333 would change the tier each year for new employees or rehired employees requiring annual reprogramming fees and changes in forms at the beginning of each fiscal year – increasing the cost to the school district.

The district's retirement office has encouraged employees to use KPERS on-line benefit calculation tools. We believe this bill would require more one-on-one staff time to articulate the retirement date differences and help employees understand the benefit calculation.

This bill would increase programming costs and may, over time, require additional staff to complete verification process that must be done when entering new or returning employees into the KPERS system.

Thank you, Mr. Chairman, for letting us share with you our concerns over additional administrative costs during a time when school budgets are facing difficult cuts and school districts are admonished to spend more in the classroom.

Mr. Chairman, in response to a question last Friday I would like to clarify Wichita Public Schools has averaged 180 KPERS retirees annually over the past three years: 202 in 2010; 163 in 2009; and 175 in 2008.

House Pensions & Benefits

Date: 3/7/2011

Attachment # 9