Joint Committee on Pensions, Investments, and Benefits

KPERS 3 Plan Design

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KPERS

Covering Today

Legislative History

- Funding Context
- 2011 Study Commission
- 2012 HB 2333

KPERS 3 Benefit Structure

Plan Design Adjustment Options and Benefit Impacts

Historical Context

Over KPERS history, the Legislature passed laws providing various benefit enhancements to KPERS members.

A significant benefit enhancement package passed in 1993, including:

- Full retirement eligibility under the "85-point rule" (when the sum of a member's age and years of service credit equals 85) or at age 62 with 10 years of service.
- An increase in the retirement formula factor from 1.4% to 1.75% for both previous and future service.
- A 15% cost-of-living increase for retirees.

To fund the 1993 enhancements the Legislature:

- Changed actuarial methods, lowering employer contributions in initial years and shifting the enhancements' costs into the future.
- Implemented a 40-year amortization period of the unfunded actuarial liability
- Added a statutory cap of 0.1% on annual increases to employer contribution rates.

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Historical Context

In subsequent years, the actuarial cost estimates of the 1993 benefit enhancements proved to be too low.

The employer contribution cap (0.1% initially) was not high enough for the statutory employer contribution rate to reach the actuarial required employer contribution rate.

- Ultimately, it took 25 years for the State/School group to reach the actuarial required employer contribution rate (FY 1996 – FY 2021).

The benefit enhancements along with subsequent experience losses contributed to long-term funding issues that emerged in 2001-2002.

Legislative Actions to Address Funding

By 2001 and 2002, actuarial projections indicated the KPERS retirement plan would not be fully funded within the initial amortization period (2033).

In 2003, the Legislature raised statutory caps on employer contribution rate increases from 0.2% annually to 0.6% by FY 2008.

The state issued $500 million (gross of fees) in pension obligation bonds in 2004.

2007 legislation established KPERS 2 for employees hired on or after July 1, 2009, which increased retirement eligibility ages and employee contributions.

Impact of the Great Recession

In 2008, KPERS experienced net investment returns totaling -28.5%.

- At the time, the investment return assumption was 8%, so the return was more than 36% below the target.

The market value of assets fell $4.3 billion, from $14.17 billion on 12/31/2007 to $9.86 billion on 12/31/2008.

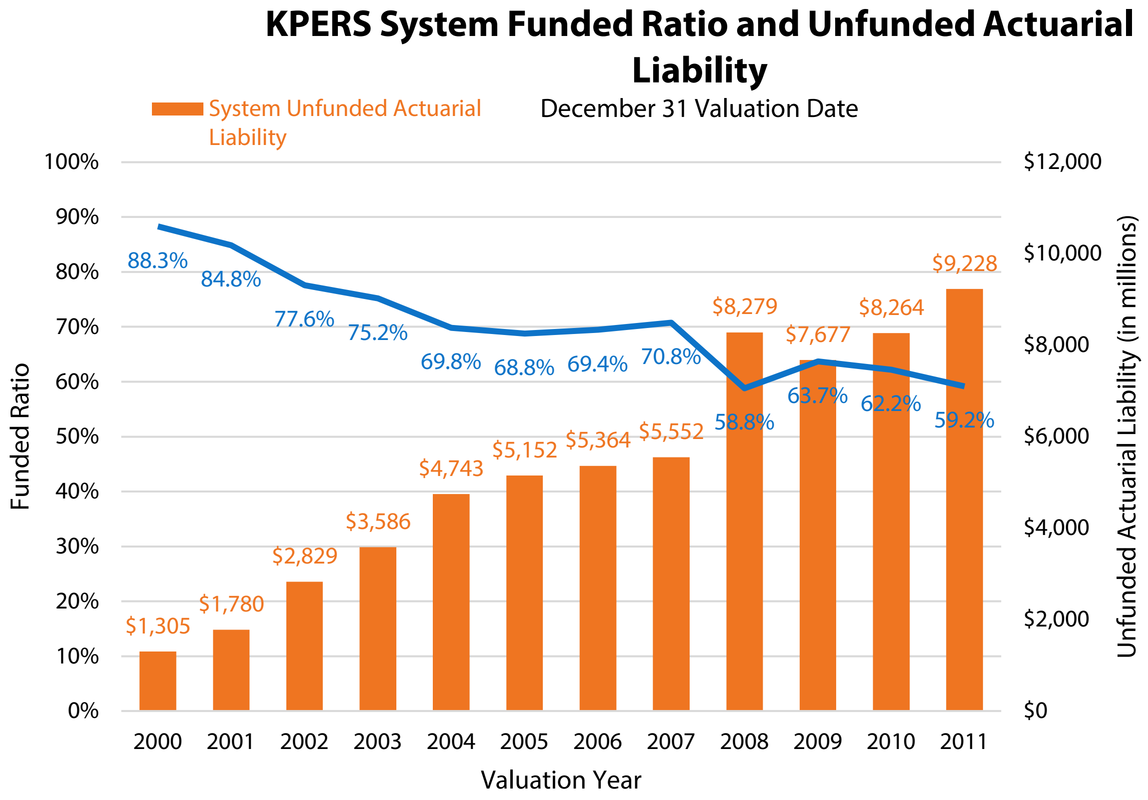
The State/School group was again projected to be out of actuarial balance; the employer contribution rate was not projected to reach the actuarial required contribution rate during the amortization period (2033).

KPERS Funding Trajectory

Leading up to 2011, KPERS funding had declined almost 30% in a decade.

Previous Legislative actions on funding were not enough to overcome the impact of two market downturns and long-term underfunding of employer contributions.

The 2011 Legislature proposed increases to employer contributions and created a study commission to propose additional legislative actions.



KPERS Study Commission

The Study Commission met for 10 days during the 2011 interim.

The Commission issued a final report in December that recommended:

- Creating a new hybrid retirement plan with a guaranteed annuity (defined benefit) and an employee-directed defined contribution for most new KPERS members (known as the King plan).
- Eliminating service purchases for KPERS 1 and KPERS 2 after July 1, 2013.
- Bonding all or a portion of the existing $8.3 billion unfunded actuarial liability.

A minority report was also filed that opposed the King plan based on complexity, not addressing the unfunded actuarial liability, and benefit adequacy.

2012 Legislation

The 2012 Legislature spent most of the 2012 session discussing the recommendations of the study commission.

Ultimately, three major changes were enacted in 2012 HB 2333:

1. **Higher employer contribution increases**. The annual cap on both State/School and Local employer contributions increases was raised from 0.9% to 1.2% over a 4-year period.

2. **Higher employee contributions**. KPERS 1 member contributions were raised from 4% to 6% over a 2-year period.

3. **Creation of the KPERS 3 cash balance plan** for new members starting January 1, 2015.

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KPERS 3 *At a Glance*

KPERS 3 is a defined benefit plan with defined contribution features.

- Guaranteed benefits
- Benefits paid for member's lifetime

KPERS 3 retirement benefits based on amounts in the member contribution account and employer pay credit account.

Retirement benefits provided as monthly income (annuity).

Members receive lifetime monthly benefits, including:

- Partial lump-sum options
- Range of survivor options

KPERS 3 *At a Glance*

For all new members who joined since January 1, 2015

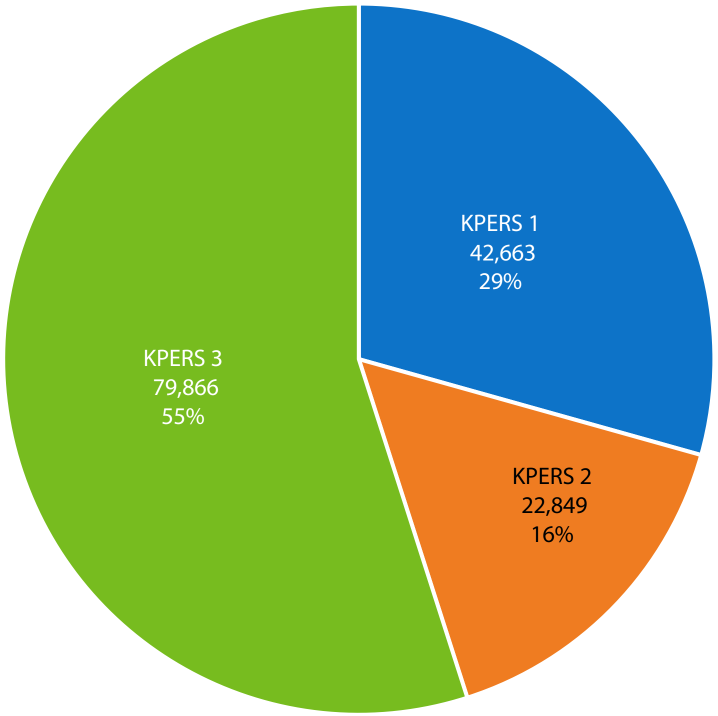
About 55% of all active members are KPERS 3 (as of 12/31/2023)

5,000 – 6,000 new KPERS 3 members each year

Concern about the adequacy of KPERS 3 retirement benefits has become a more common topic of discussion over the past 3 years

Improvements to KPERS 3 are possible, but come with increased costs to the Retirement System

KPERS Active Membership
December 31, 2023



Total Active Members: 145,378

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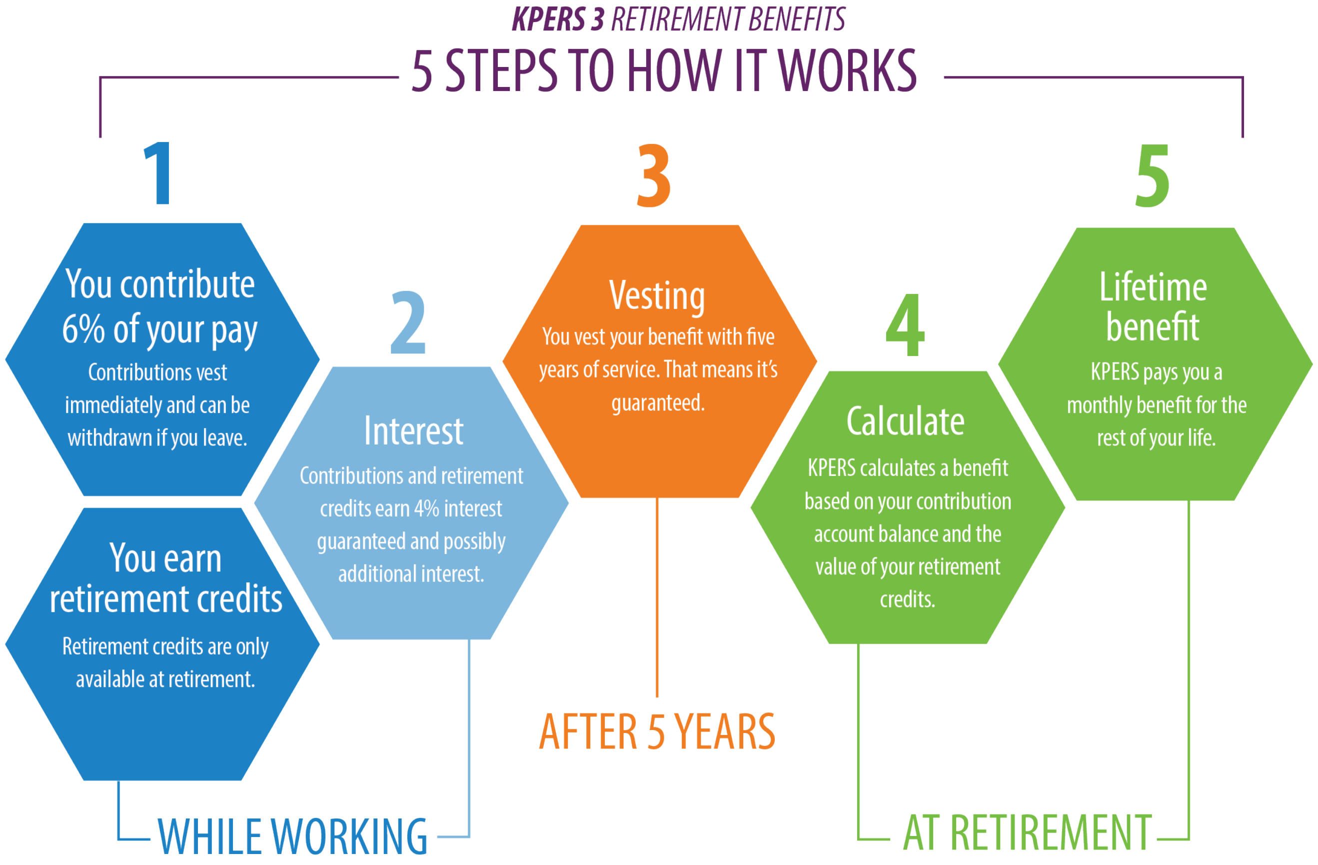
KPERS 3 Cash Balance Plan



KPERS 3 Audit

Legislative Post Audit reviewed the KPERS 3 design compared to other public retirement plans.

The report recognized that the plan design was intended to improve long-term funding, but focused on the benefit levels provided by the KPERS 3 plan design.

> *"KPERS 3 gives employees less flexibility, requires them to share some financial risk, and generally provides lower benefits than other plans…evaluated."*
>
> *– Legislative Post Audit Report on KPERS 3 (February 2024)*

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Recent Legislation

The 2024 Legislature introduced bills in the House and Senate to move all or a group of KPERS 3 members back to KPERS 2.

- ***Projected Impact:*** Increase unfunded actuarial liability by approximately $632 million. This will increase over time as there are more KPERS 3 members and longer service time.
- ***Projected Impact:*** Increase State/School normal cost by 1.07% (to 9.90%) and Local normal cost by 1.23% (to 9.34%)

This was the first time there had been bill hearings on changing KPERS 3 to another defined benefit plan design.

- There have been broader discussions on moving to a defined contribution plan design, but not specific to KPERS 3.

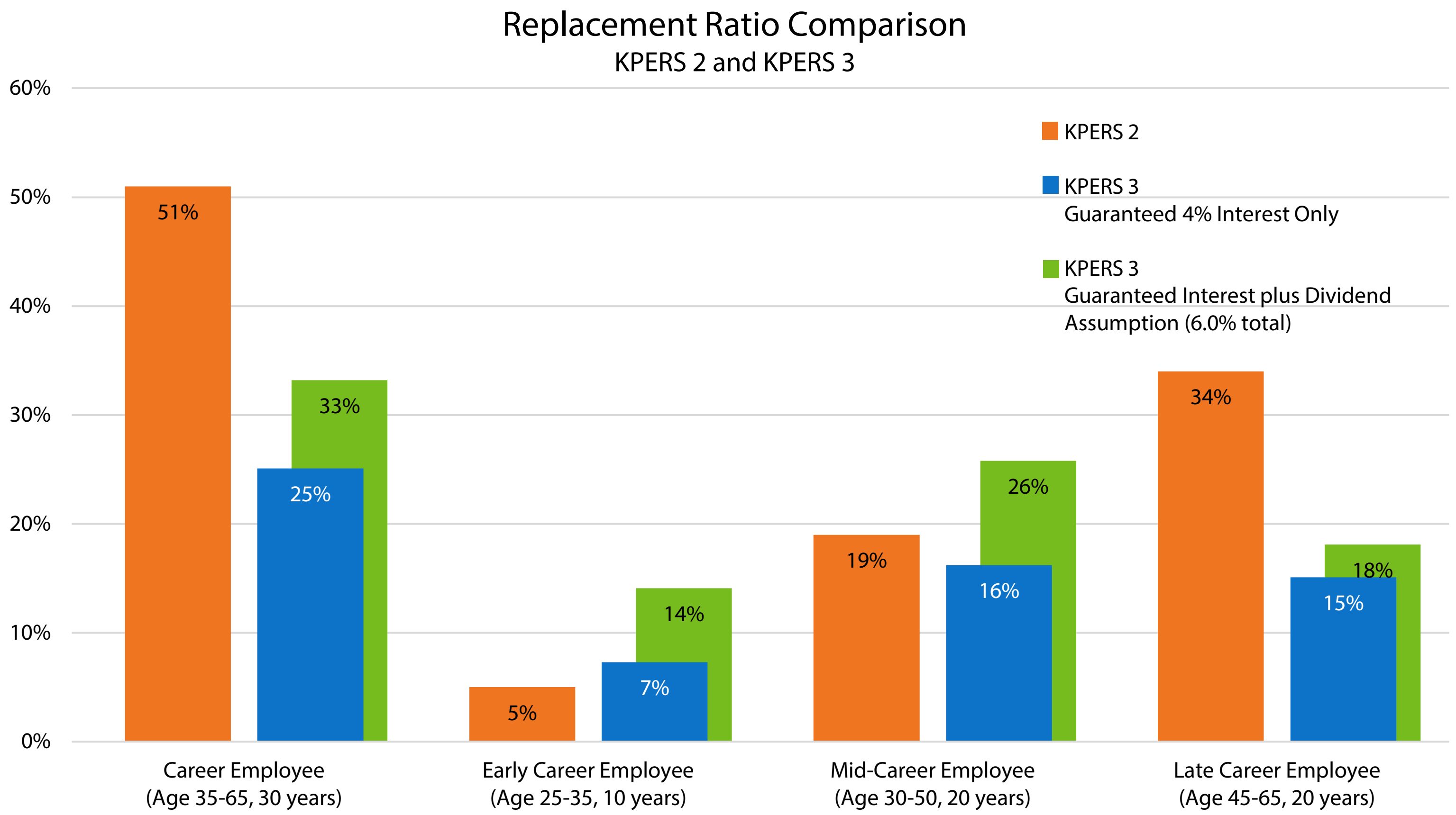
Benefit Comparisons

With KPERS 3 being only about 10 years old, there is not enough experience to make direct comparisons between KPERS 1, KPERS 2 and KPERS 3 retirement benefits.

We have calculated replacement ratios using a range of scenarios to show what percentage of a member's pre-retirement income may be replaced by their KPERS 3 retirement benefits.

These estimates depend on several assumptions, such as investment returns and a member's years of service.

Replacement Ratios for KPERS 2 and KPERS 3



All scenarios assume that the member retires at age 65 and reflects the current set of actuarial assumption, including the 7.0% investment return assumption.

A replacement ratio is a measure of a person's pre-retirement income that will be replaced by retirement benefits.

Most studies suggest a target of 70% to 80% of pre-retirement income is necessary to maintain a person's lifestyle in retirement.

KPERS benefits are only one part of a person's total replacement ratio, along with Social Security and personal savings.

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New Comparison

The replacement ratio comparison relies on assumptions under various scenarios.

For some, the use of so many scenarios makes it hard to understand.

A real-world comparison is still anecdotal but gives a comparison of an actual member's experience.

Jane Q. Public

Jane joined the State of Kansas in the fall of 1997 at age 40. She became a KPERS 1 member in 1998 after her statutory year of waiting.

Jane stayed with the state for 26 years, retiring in 2023 at age 66. She retired with 25 years of service because she opted not to purchase her year of waiting.

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Jane’s Retirement Benefit

As a KPERS 1 member, Jane’s benefit was calculated by multiplying:

- The average of her highest three years of salary ($63,937)
- 25 years of service
- 15 years of 1.75% multiplier and 10 years of 1.85% multiplier

Jane’s 10-year life certain benefit, totals **$27,181 per year**.

Compared to her final year’s salary of $65,468, Jane’s KPERS 1 benefit replaced 41.5% of her working income at retirement.

Jane is also covered by social security and will receive approximately $24,500 per year.

What if Jane Was a KPERS 3 Member?

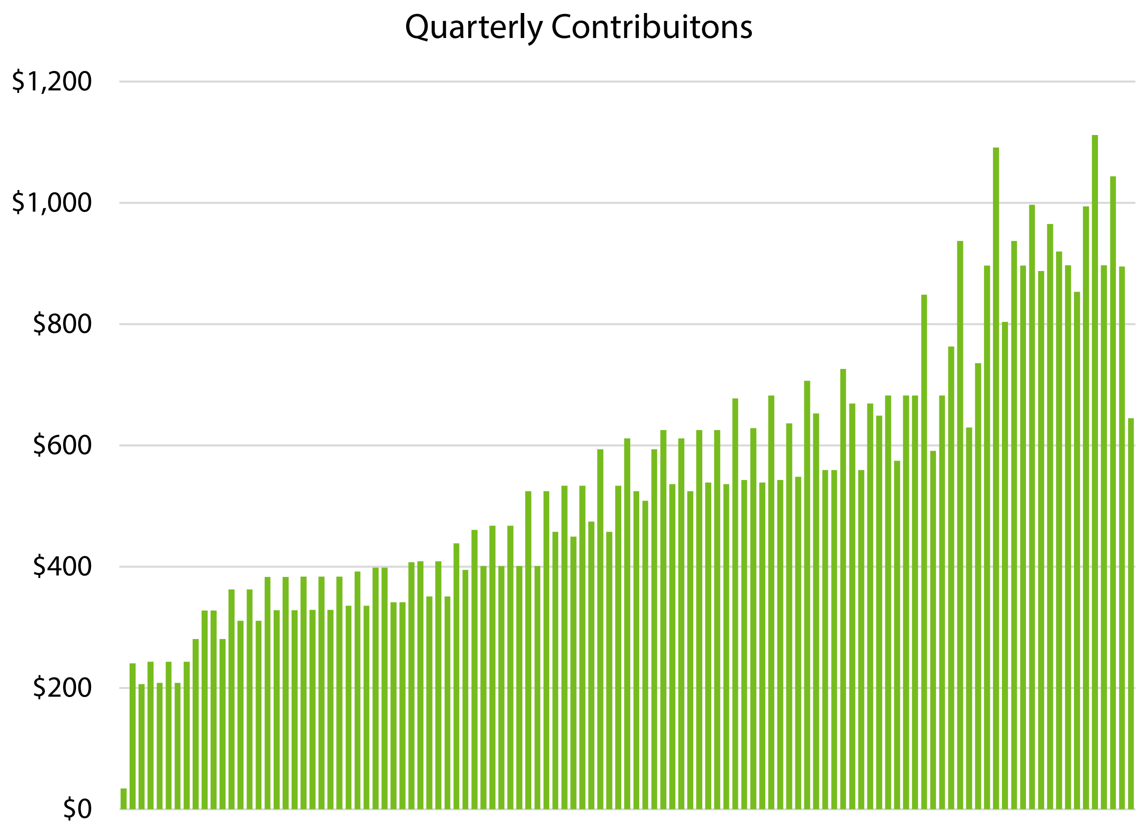
If the KPERS 3 cash balance plan had been in place in 1997, Jane's benefit calculation would look very different.

Using historical payroll and actual investment return information, we can calculate what Jane's KPERS 3 benefit would be.

Contributions/Employer Pay Credits

Let's use Jane's quarterly wages to calculate her member contributions and employer pay credits:

- **Total Member Contributions (6%):** $56,625
- **Total Employer Pay Credits (3-6%, Based on Years of Service):** $45,430



Interest Credits

Dividend Interest Credits			
Year	**Dividend**	**Year**	**Dividend**
1997	5.100%	2010	-%
1998	5.475%	2011	-%
1999	8.025%	2012	-%
2000	3.900%	2013	5.550%
2001	1.050%	2014	3.150%
2002	-%	2015	1.125%
2003	-%	2016	2.475%
2004	-%	2017	2.400%
2005	-%	2018	-%
2006	3.000%	2019	0.825%
2007	5.625%	2020	2.475%
2008	-%	2021	3.525%
2009	-%	2022	-%

Jane's contributions and employer pay credits receive 4% guaranteed annual interest, credited quarterly.

Jane also receives dividend credits on her December 31 account balance in years when the 5-year average net return exceeds 6%. This occurs 15 times in 26 years. The compound dividend credit over Jane's career is 2.04%.

- **Total Interest Earned – Member Contributions:** $49,632
- **Total Interest Earned – Employer Pay Credits:** $34,067

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KPERS 3 Account Balances

Based on her contribution/employer pay credits and interest information, here are Jane's account balances at retirement:

Jane's Account Balances at Retirement	
Member Contributions Account	$106,258
Employer Pay Credit Account	$79,497
Total KPERS 3 Account Balance	**$185,754**

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Annuitizing Account Balances

Using the statutory annuitization rate (2% less than the investment return assumption) along with the mortality assumption, the actuary calculates annuity factors used to convert account balances to annuity benefits.

Since Jane retired at age 66, her annuity factor for the base KPERS 3 benefit (10-year life certain) is 13.061217.

To calculate Jane's annual benefit, we'll divide her total KPERS 3 account balances by the annuity factor.

Member Contribution Account	$106,258
Employer Pay Credit Account	$79,497
Total Account Balances	$185,755
Annuitization Factor	13.061217
Benefit Amount	$14,222
Jane's Final Year Salary	$65,468

Jane's KPERS 3 Benefit Amount Replaces:
21.7% of her pre-retirement income

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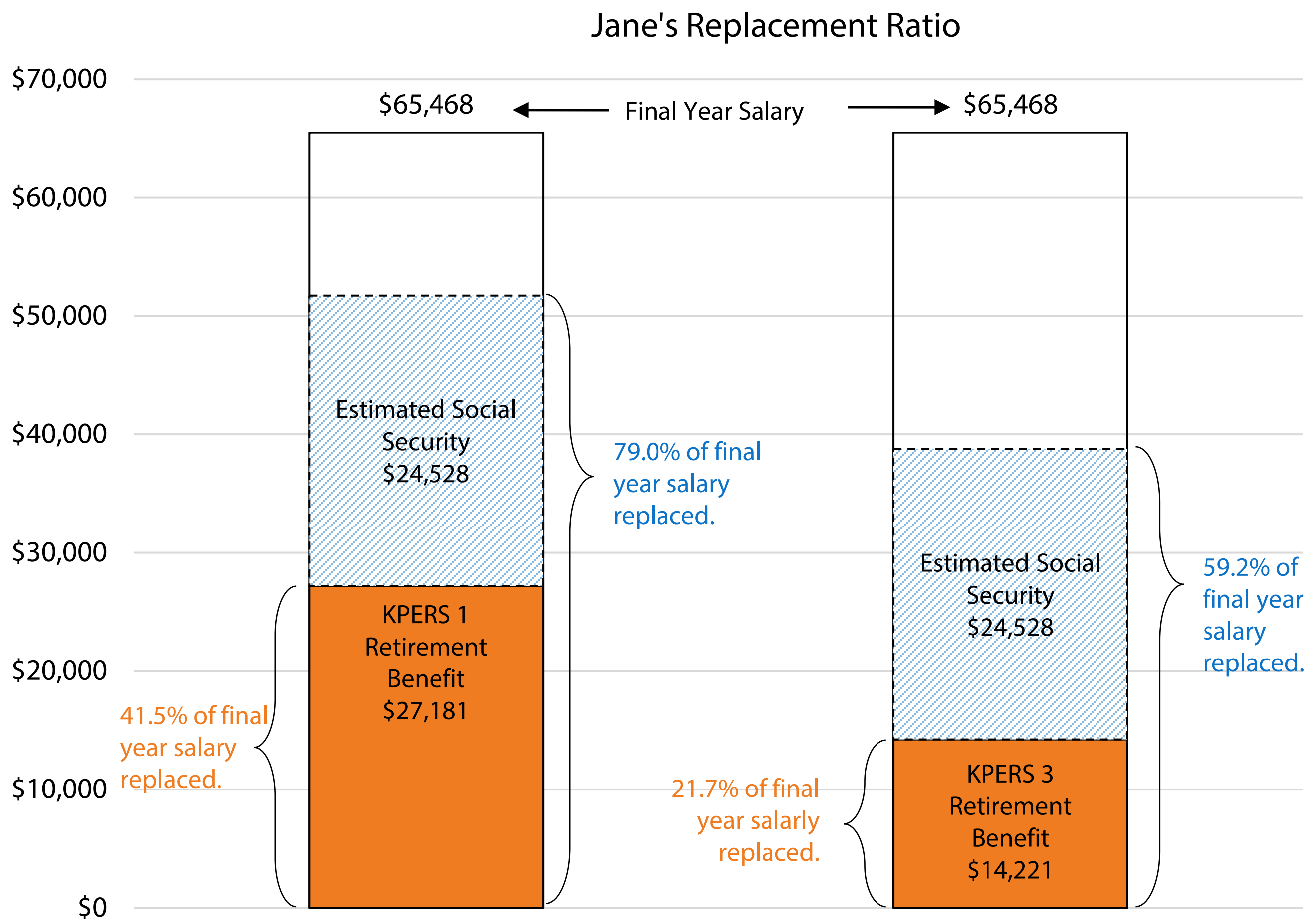
Jane’s Benefit Comparison



Replacement ratios will vary for each person depending on their actual career experience.

Actual investment returns, hire age, salary progression, retirement age, and benefit options all effect a member’s benefit amounts.

Jane’s experience is one example, but every member will be slightly different.

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Opportunities for Improvement

Employer Pay Credits

- 3% to 6% based on years of service

Interest Credits

- 4% guaranteed annually, credited quarterly
- Variable dividend equal to 75% of the 5-year average return above 6%

Annuitization Rate

- 2% less than the investment return assumption (currently 5%)

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What if…

…employer pay credits started at 4% and went to 7% (versus 3% to 6%)?

		Dollar Change	Percent Change
Employee Contribution Account	$106,258		
Employer Pay Credit Account	$97,206	+$17,709	+22.3%
Total Account Balances	$203,464	+$17,709	+9.5%
Annuitization Factor	13.061217		
Benefit Amount	$15,578	+$1,356	+9.5%

Years of Service	Annual Rate
1-4	4%
5-11	5%
12-23	6%
24+	7%

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What if…

… the guaranteed interest credit was increased from 4% to 5%?

		Dollar Change	Percent Change
Member Contribution Account	$120,410	+$14,152	+13.3%
Employer Pay Credit Account	$88,900	+$9,403	+11.8%
Total Account Balances	$209,310	+$23,555	+12.7%
Annuitization Factor	13.061217		
Benefit Amount	$16,025	+$1,803	+12.7%

4% → 5%
Guaranteed Interest

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What if…

…the dividend interest credit formula was changed to 75% of the 5-year net average rate of return above 5%?

		Dollar Change	Percent Change
Member Contribution Account	$113,054	+$6,796	+6.4%
Employer Pay Credit Account	$84,130	+$4,633	+5.8%
Total Account Balances	$197,184	+$11,429	+6.2%
Annuitization Factor	13.061217		
Benefit Amount	$15,097	+$875	+6.2%

Dividend Interest Credits

Year	Dividend	Year	Dividend
1997	5.850%	2010	-%
1998	6.225%	2011	-%
1999	8.775%	2012	-%
2000	4.650%	2013	6.300%
2001	1.800%	2014	3.900%
2002	-%	2015	1.875%
2003	-%	2016	3.225%
2004	-%	2017	3.150%
2005	0.600%	2018	0.075%
2006	3.750%	2019	1.575%
2007	6.375%	2020	3.225%
2008	-%	2021	4.275%
2009	-%	2022	0.525%

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What if…

…the annuity rate was 6% instead of 2% less than the investment return assumption?

		Dollar Change	Percent Change
Member Contribution Account	$106,258		
Employer Pay Credit Account	$79,497		
Total Account Balances	$185,755		
Annuitization Factor	11.9702		
Benefit Amount	$15,518	+$1,296	+9.1%

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What if…

…pay credits, guaranteed interest, dividend interest and annuity rate all changed?

		Dollar Change	Percent Change
Member Contribution Account	$128,357	+$22,099	+20.8%
Employer Pay Credit Account	$115,651	+$36,154	+45.5%
Total Account Balances	$244,008	+$58,253	+31.4%
Annuitization Factor	11.9702		
Benefit Amount	$20,385	+$6,163	+43.3%

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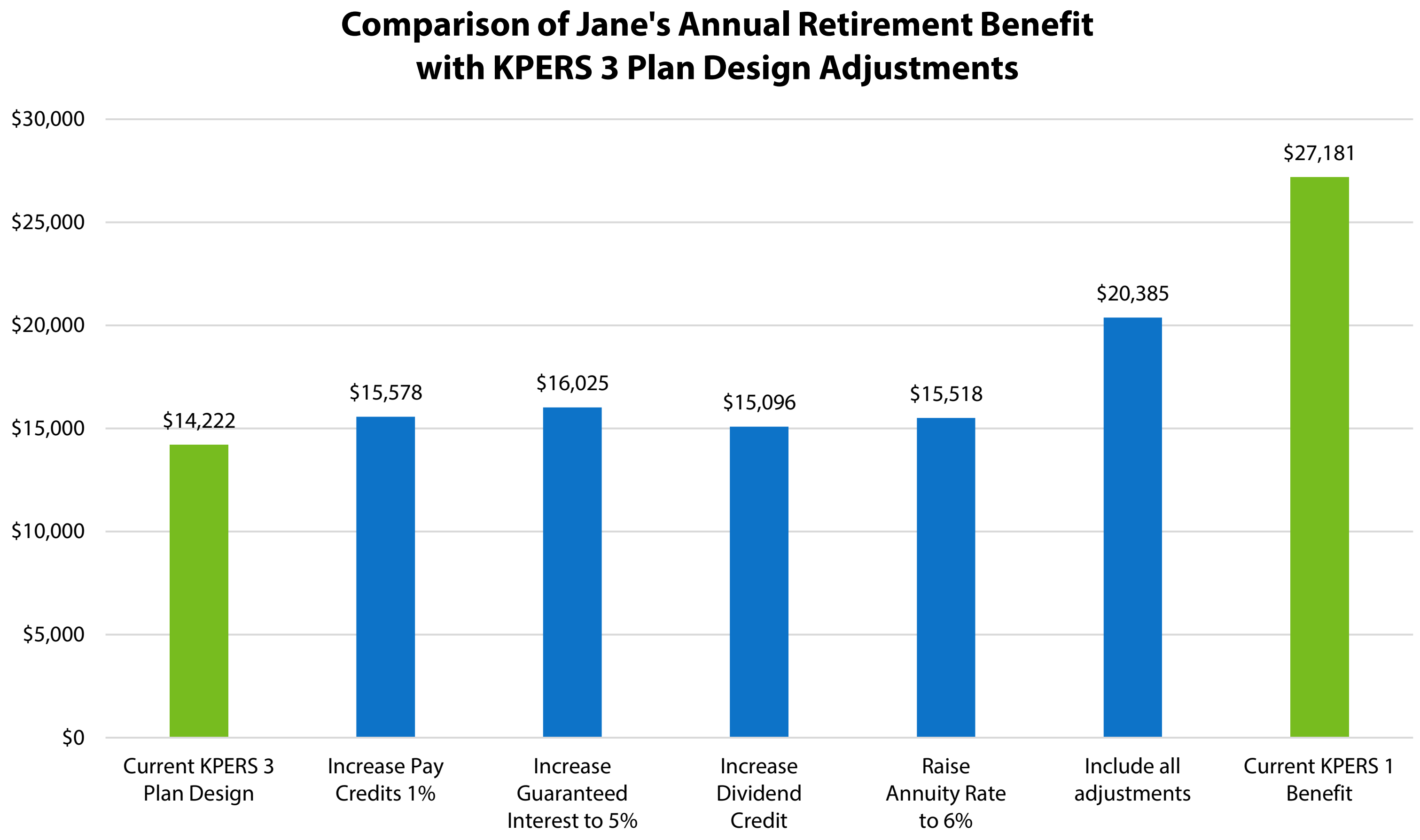
Benefit Comparisons



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Cost Estimates

Changing the KPERS 3 plan design to improve benefit amounts will increase the cost of the plan.

Not all changes have equal impact:

Change to Benefit Structure	Estimated Normal Cost Increase	Estimated State/School Contribution Increase
Increase the employer pay credit by 1% for all years	+0.65%	$38.3 million
Increase guaranteed interest rate by 1%	+1.23%	$72.5 million
Increase the annuity interest rate by 1%	+0.41%	$24.2 million

Based on 12/31/2022 actuarial valuation

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Conclusion

If KPERS 3 is not meeting its objectives, there are options to modify the plan design to enhance benefits for members while maintaining the cash balance plan.

Any adjustments to improve KPERS 3 benefits will result in **higher costs to the system**, requiring careful consideration of the financial impact on employers and the overall sustainability of the plan.

Over time, the up front cost of changing the KPERS 3 plan design will increase as there are more active members and longer service time.

Questions?

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