

Kansas Public Employees Retirement System

Testimony on SB 338/HB 2545 Administrative and Technical Issues

Presented to the
Senate Select Committee on KPERS

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Chairman Morris and Members of the Committee:

Thank you for the opportunity to appear today and provide testimony on administrative and technical issues related to the new KPERS plan design recommended by the KPERS Study Commission and contained in SB 338 and HB 2545 as introduced.

As the Committee has had previous opportunities to review the new plan design established by these two bills, I would like to preface my discussion of administrative and technical issues with several comments about their context.

Ongoing evaluation of administrative impact, technical issues, and cost estimates. The new plan design has been evolving throughout its consideration by the Study Commission, the process of drafting legislation, and its subsequent consideration by the Legislature. Therefore, KPERS' evaluation of the new plan design's operational impact and administrative issues is and will remain a work in progress.

The extent and complexity of the new plan design exceeds that of any other legislation previously implemented by KPERS, and therefore, prior administrative experience does not provide useful benchmarks for assessing cost and staffing impacts. Moreover, while there are other state retirement plans that have implemented plans that have one or more components similar to aspects of the HB 2545 plan design, there are no exact parallels to this particular plan design. Therefore, cost estimates remain under development. Those administrative requirements and issues that we have identified and expect to have a cost are described below. While it is my expectation that we will be prepared to provide preliminary cost estimates in the near future, they will continue to be developed and revised throughout legislative consideration of the new plan or modifications to it.

Although I cannot provide you today with actual cost estimates, it is clear that the fiscal impact on KPERS' administrative and operational costs is expected to be large, relative to KPERS' current administration budget. This is consistent with testimony the Study Commission received from the Washington Department of Retirement System. In discussing their hybrid plan, the Deputy Director indicated that "implementation costs can be significant." More specifically, Washington



Department of Retirement System projected implementation and ongoing costs of nearly \$15 million over a four-year period (FY 2000 through FY 2003) and ongoing costs of over \$5.5 million for the following FY 2003-2005 biennium. While it can be difficult to compare costs from one system to another, their experience suggests that a major increase in KPERS funding would be required during implementation, with significant ongoing costs.

Costs associated with implementing the proposed plan design may be larger proportionally for KPERS, given the very lean operating structure currently in place. A "CEM Benchmarking" study of 88 pension systems, including 14 specifically identified as appropriate peers to KPERS, was presented to the Board in May 2011. The study indicated that, at \$44 per active member, KPERS' pension administration costs were far below that of its peer group and the entire universe studied.

- KPERS' cost per active member is \$46 below the peer average of \$90 and 4th lowest in the entire benchmarking study universe.
- KPERS has only 2.95 pension administration FTE per 10,000 members, which is less than half the peer average of 7.10 FTE.

Implementation and administration of HB 2545 would affect all aspects of KPERS operations. Preliminary highlights of its impact with respect to employer reporting; contracts and interfaces with third parties; trust structures; information systems; member and employer communications, education and support; administrative funding sources; staffing and operational expenses; the bill's effective date; and technical or mechanical issues are discussed below.

Fiduciary responsibility. The Legislature carries the primary responsibility for KPERS' plan design. KPERS Board of Trustees generally does not advocate for or against particular plan designs, except to the extent a plan design may be inconsistent with federal law or fiduciary duties. Among the fiduciary duties of KPERS Board of Trustees are –

- Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them
- Carrying out its duties prudently
- Following plan documents and /statutes, and administering the plan(s) in a manner that preserves qualified plan status.
- Selecting and monitoring a set of diversified plan investment options
- Paying reasonable, not excessive, plan expenses
- Providing comprehensive, clear information with which members can make an informed decision (e.g., regarding elections or, in the case of a defined contribution plan, investment options)
- Administering all components of the System in a manner that ensures contributions are credited and benefits are paid in a timely and accurate manner, whether directly or through a third party administrator for a defined contribution plan.

Many of the administrative issues described below are related to one or more of these fiduciary duties. Therefore, KPERS must evaluate those administrative issues in light of its fiduciary duty to members of both the existing defined benefit plan and the new plan.

Complexity and time constraints. As KPERS has reviewed the new plan design, two overarching and related concerns have emerged – the plan's complexity and its implementation

timeframe. Multiple levels of administrative and legal complexity are introduced as a result of simultaneous elections under HB 2194 and the new plan; the plan's approach to crediting interest to the employer annuity account; the separation of the employee-directed accounts into two different plan types based on employer or job type (a 403(b) vs. a plan established under IRC 401(a), 414(d), and 414(k)); creation of two custom default investment options, including one that is a part of the KPERS defined benefit portfolio and the second in an external investment vehicle for the 403(b) plan; and a highly compressed implementation period. To varying degrees, this complexity would need to be managed not only by KPERS, but by 1,500 participating employers as well.

The new plan design not only represents a fundamentally different approach to retirement plan funding, benefits, and administration compared to the existing defined benefit plan, but it also involves closing Tier 2 to new members. New Tier 3 members will be considered to be part of the KPERS plan. Tier 3 assets will be treated as part of the KPERS Trust Fund with respect to the assets in the cash balance portion of the plan and the employee-directed portion that is established under IRC sections 401(a), 414(d), and 414(k). However, the employee-directed plan established under 403(b) cannot be considered part of the KPERS Trust Fund. Therefore, this multi-plan, multi-trust design would require a more comprehensive analysis and identification of a wide range of legal, financial reporting, funding, administrative, and technical issues during the implementation period.

A more detailed description of key administrative impacts and issues follows. If taken individually, most of them could be adequately addressed given sufficient time and funding. However, their cumulative impact raises concerns about KPERS' ability to successfully implement the new plan design without the necessary resources.

Employer Reporting

Implementation of a defined contribution plan would require KPERS and all of the 1,500 KPERS employers to make changes to their payroll and accounting systems. In particular, each employer's payroll system would need to have the capability to promptly remit and reconcile each contribution rate element for the payroll, unlike the current annual reporting process in place. Federal law establishes requirements relating to timely deposit of employee contributions to defined contribution plans such as the employee-directed accounts. For this reason, it is assumed that the employer would transmit directly to a third-party record keeper the employee-directed account contributions, and that other employer contribution components (e.g., a blended rate for the employer contributions to Tiers 1 through 3; the employer-paid death and disability benefit rate; and any administrative expense rate) would be paid to KPERS on the same compensation amount.

One long-standing characteristic of KPERS' existing administrative structure is annual employer contribution reporting. Employer¹ and member contributions are both forwarded to KPERS within three days of the pay date, along with a remittance report containing summary data.

¹ Employer contributions for the School Group are remitted on a quarterly basis as the school districts receive their share of the State General Fund appropriation for KPERS employer contributions.

However, employer reporting as to individual member data and reconciliation with that year's remittance reports are completed by KPERS and participating employers on an annual basis. The annual reporting does not include salary data – that year's compensation for each member is calculated based on contributions received. Moreover, employees may work for more than one participating employer concurrently, without the knowledge of the other employer. Therefore, KPERS does not currently receive or maintain year-to-date compensation data for each member.

In order to ensure that the proper amount of both employee and employer contributions are remitted and recorded on a timely basis, implementation of a defined contribution plan would entail a shift from this long-standing process for KPERS' defined benefit plan reporting and reconciliation. Implementation of HB 2545/SB 338 would require reporting of compensation and contribution amounts for members each payroll period so that Tier 3 employee contributions are promptly credited to their employee-directed accounts and the corresponding employer contributions are properly calculated and collected on a timely basis. This shift comprises a major element of the IT system modifications that KPERS would need to undertake. The change in reporting scope and frequency also is likely to entail significant information system and other operations costs for each employer.

Administration of 403(b) plans. The Board is to establish two types of employee-directed accounts:

- A "403(b) plan" is to be established under that section of the IRC. This 403(b) plan would be applicable to qualifying public school employees, community college employees and other eligible employees under section 403(b). Further analysis will be required to determine whether KPERS' membership includes any employees who qualify for a 403(b) plan other than as a public school or community college employee. The Board is to establish a separate account for each 403(b) member, which is to be administered in accordance with section 403(b).
- For all other members, a defined contribution plan component is to be established as a part of the existing KPERS plan and as a qualified governmental plan under IRC sections 401(a), 414(d), and 414(k). Its assets are to be held in the existing KPERS Trust. The Board is to establish a separate account for each member, which is to be administered in the nature of a defined contribution plan, as provided by section 414(k).

A mandatory amount equal to 6% of compensation is to be contributed to the employee-directed account of each Tier 3 member, as follows:

- For 403(b) participants, each participating employer must contribute the 6% mandatory contribution, up to the maximum amount allowed by the IRC. KPERS is assuming that, while the 6% contribution is characterized as an employer contribution, it does not represent an additional 6% of compensation beyond the service-based contributions to the employer annuity account, but is a mandatory salary reduction contribution under section 403(b). Because these accounts are established under a separate plan, they cannot be held within the existing KPERS Trust. Eligible employees in the 403(b) plan may contribute an additional, discretionary contribution through payroll deductions on a pre- or post-tax basis, up to the applicable IRS limits.
- For all other members, each active member must contribute the mandatory 6% of compensation, up to the maximum amount allowed by the IRC. These contributions are to

be picked up by the employer via a salary reduction as provided by section 414(h)(2) of the IRC. No additional, discretionary contributions to the employee-directed account are permitted.

As noted earlier, KPERS is currently assuming that employee contributions would be sent directly to a third-party record keeper. However, this assumption will need further evaluation given potential administrative complexities that could be associated with establishing the separate 403(b) plan for school and other eligible members. Many school employers currently offer supplemental 403(b) plans, in some cases using multiple investment providers. Under IRS requirements for 403(b) plans, the KPERS 403(b) plan would have to be coordinated with these other 403(b) plans offered by KPERS employers to their eligible employees. Coordination requirements would include:

- Applying limits on *contributions* to all 403(b) plans of the same employer. This means that, if an employee is already “maxing out” under his/her existing 403(b) plan, the contributions under this new 403(b) plan would not be made or would be limited. Clarification as to which plan would take precedence between plans should be provided – i.e., should contributions to employer-provided supplemental 403(b) plans be permitted only to the extent that the applicable limits are not exceeded after accounting for the 6% contribution to the KPERS 403(b) plan?
- Coordinating *distributions* in order to meet federal law requirements, such as minimum distributions, limits on loans, and limits on hardship distributions.

From a practical standpoint, this means that KPERS would have to retain the services of a record keeper to assure compliance with coordinated limits. In the alternative, KPERS would need to “staff-up” to perform this function. Moreover, HB 2545/SB 338 does not provide any limits on the number of vendors who could offer the KPERS 403(b) plan. KPERS has been advised that, if a large number of vendors do provide separate recordkeeping and investments under this 403(b) plan, the duplication of effort and the coordination of tasks would be difficult and costly. However, the actual cost analysis of vendor selection would need to be performed by an investment or employee benefits consultant.

Given the complexities that would be involved with multiple investment providers, it may become necessary to design contribution remittance and reporting processes that are centralized through KPERS, rather than routing employee contributions directly to a third-party provider. Some larger state retirement systems with a defined contribution plan component, such as Washington, function in this manner. While this approach may provide some efficiencies and lower costs for KPERS employers, it is expected that it would significantly add to the cost and staffing requirements for KPERS, both during implementation and on an ongoing basis.

Service Provider Contract and Other Service Contracts

Establishing the employee-directed accounts would require the KPERS Board to contract for plan administration, consulting, investment, educational, recordkeeping and other services for the defined contribution components of the plan.

It is assumed that many of the day-to-day responsibilities associated with establishing and maintaining the individual defined contribution plan member accounts would be performed by a service provider (also referred to as a third-party record keeper). The third-party administrator's duties typically include investing plan assets in accordance with plan documents and member direction, crediting employer and employee contributions, valuing assets in each member's account, processing distributions, providing guidance and assistance to members on a personal basis and through phone, written, and electronic communications, and providing communication and education services. Payment sources (such as asset-based or per account or per transaction fees) and amounts for service provider costs would be negotiated as part of the competitive proposal process.

Consideration will need to be given as to the nature and extent of electronic interfaces between KPERS, the third-party administrator, and employers, considering such issues as accessibility of information for KPERS, employees, and employers; efficiency; duplication of effort and records; and the costs of the interface. Minimum interfaces required will include enrollment, contribution and compensation reporting and remittance, and changes in employment status (e.g., leave without pay or terminations). More extensive interfaces could be added that would allow for KPERS, the employer, or both to enroll members on a real-time basis or to access account balances, investment returns, beneficiary designations, and similar member account details on a daily basis.

Two factors are likely to increase the complexity and cost of providing these services – the provision of an investment option similar to the KPERS defined benefit portfolio and its use as the default investment option; and the 403(b) plan structure established for a large segment of Tier 3 members.

KPERS Portfolio Investment Option. Subsection (a) of Section 6 provides that all employees are to be offered an investment alternative that is similar to the investment portfolio of KPERS. Such an investment alternative can be offered as part of the defined benefit portfolio for the 401(a)/414(d)/414(k) employee-directed accounts, because those accounts will be part of the KPERS trust. This approach would seem to be most consistent with the intent expressed by the Commission to provide Tier 3 members with an investment alternative that takes advantage of the defined benefit portfolio's asset diversification, economies of scale and professional management. KPERS would require the support of investment, defined contribution plan, legal, and accounting consulting services in order to develop such an investment alternative. Among the considerations that would need to be addressed are –

- The extent to which the defined benefit portfolio's asset mix can and should be incorporated into the investment alternative, given fiduciary, cash flow, and valuation issues.
- The manner in which the investment alternative would be valued and the frequency of valuations. Although mutual funds are typically valued on a daily basis, KPERS portfolio contains a number of investments that are not publicly traded and, therefore, cannot readily be valued in that manner (e.g., private equity and private real estate). Therefore, it is assumed that valuation of the investment option would be on a monthly basis, which is the approach used by the State of Washington with the "total allocation portfolio" offered to its Plan 3 members.

- What interfaces with the third-party record keeper would be required in order to transmit funds into and out of the defined benefit portfolio investment option within the existing defined benefit portfolio and to maintain and update individual account data on the third-party administrator's record-keeping and investment platforms.
- Section 6(c) requires that a default option be "the fund that is similar to the investment portfolio of KPERS." First, the selection of a default option is usually a fiduciary function and the purpose of the default option is to provide a somewhat conservative or balanced option. The KPERS portfolio may or may not meet that criteria. The KPERS Board would have to consider its fiduciary duty as it constructed this default option that was "similar" to the KPERS portfolio. With regard to the 403(b) plan, the default option would be an investment alternative provided by the vendor(s). The KPERS Board would have to establish parameters in the exercise of their fiduciary duty.

Costs associated with consulting services, establishing a monthly valuation process, and interfaces with the third-party record keeper, as well as the impact of this feature on the cost of third-party administrator services are not known at this time.

This subsection appears to also require that the defined benefit portfolio investment alternative be offered in the 403(b) plan. As stated above, the investments of the 403(b) plan would not be part of the KPERS assets. Therefore, the 403(b) vendor(s) would have to structure and offer an investment alternative that was similar to the KPERS portfolio. The KPERS Board would have to interpret that provision as part of the competitive process to determine which vendor(s) could structure and offer an investment alternative similar to the KPERS portfolio. The extent to which such a vehicle could be customized within the 403(b) framework would require further review. There would also have to be a mechanism to require the vendor to change its investment alternative as the KPERS portfolio changes. Moreover, the 403(b) investment vehicle would not have the economies of scale available with a defined benefit portfolio investment alternative that is part of the KPERS Trust. We are not aware of other 403(b) plans operating in this manner.

An alternative structure may be available in which a group trust is created for the KPERS Trust and the new 403(b) plan, but such a group trust could only include any custodial accounts that were established under the plan. No analysis of the benefits, disadvantages, costs, and resources required for such a structure is currently available.

Multiple 403(b) providers. As noted previously, if multiple vendors are providing separate recordkeeping and investments under the KPERS 403(b) plan, it would be necessary to establish a means to coordinate both contributions and distributions from each of those providers, as well as with any other 403(b) plans offered by KPERS employers to their eligible employees, in order to ensure compliance with IRS limits and requirements. Spreading record-keeping services among multiple vendors in this fashion would be expected to increase the administrative costs and complexity for the KPERS 403(b) plan. Further investigation into potential arrangements available within the industry would be needed before cost implications can be fully understood.

Trust Structure

While a defined benefit plan can include more than one tier, with assets for each tier commingled, a defined benefit plan and a defined contribution plan must have separate trusts under federal law.

Nonetheless, there are possible hybrid designs in which a defined benefit plan can contain both defined benefit and defined contribution components, whereby some or all plan assets are available for both components. That is the structure created by HB 2545/SB 338 with respect to the employer annuity account and the employee-directed account established under IRC sections 401(a), 414(d), and 414(k). However, the employee-directed accounts established under IRC section 403(b) cannot be contained within this hybrid design and must be treated as a separate defined contribution plan.

There are a number of administrative and cost implications arising from this structure. As previously noted, the 403(b) assets generally cannot be commingled for investment purposes with the existing KPERS assets. The exclusive benefit rule would prevent that commingling,² thereby precluding their investment as part of a KPERS portfolio investment option. Instead, a separate investment option outside of the KPERS Trust that shares similarities with the KPERS portfolio would need to be established in order to meet the requirements of HB 2545/SB 338 to make such an option available to all Tier 3 members. In addition, the exclusive benefit rule would preclude expenditure of fund and use of resources attributable to the KPERS Trust on behalf of the 403(b) plan and vice versa. Consistent with this principle, a separate account for paying plan administrative expenses would need to be established for the 403(b) plan. Additional research will be needed into the extent to which KPERS would be required to establish operational and accounting controls segregating or allocating costs and administrative resources between the KPERS Trust and the 403(b) plan. These controls would be further complicated by the structure of Tier 3 in which each member participating in the 403(b) plan would also be covered by the employer-annuity account within the KPERS Trust.

Information System Modifications

A key cost component under HB 2545/SB 338 would be information technology costs, particularly during the start-up and implementation phase. Although many responsibilities for recordkeeping, investment management, and communication/education services would be handled by a third-party administrator, implementation of a defined contribution plan would involve major changes to KPERS' information systems.

The transition to reporting by payroll period described previously would be significant for KPERS' information systems and hardware requirements. An increase in electronic reporting by employers would add a lot of incoming communications to KPERS' network, which would require additional servers to manage the load. Fail-over servers to protect against hardware failure of the primary devices would also be required. For employers that do not transmit information electronically, the capabilities of KPERS' web portals would need to be enhanced to

² The most fundamental rule is the "Exclusive Benefit Rule. Internal Revenue Code ("Code") § 401(a) requires that the plan of the employer be "for the exclusive benefit of [the employer's] employees or their beneficiaries" Therefore, the plan may not benefit a person other than the employees or their beneficiaries. Accordingly, the Internal Revenue Service ("IRS") has held that "funds accumulated under a qualified plan in trust are intended primarily for distribution to employee participants." Rev. Rul. 72-240, 1972-1 C.B. 108. This also means that investments made on behalf of the employees must be for the exclusive benefit of those employees and their beneficiaries. See also Treas. Regs. § 1.401-1(a)(3)(ii)-(iv). This rule is the "bedrock" of guidance and statements that indicate that the assets of one plan may not be used to satisfy the liabilities of another plan. This rule looks at the use of trust assets to be sure all assets are used solely for the purposes of that trust.

handle the load of additional logins to update pay information. Significant growth in the amount of data being stored would also be expected. This growth would not only affect the need for expanded data storage capacity, but it would also have a secondary impact on KPERS' disaster recovery capacity needs. With these increased demands on KPERS' information systems, higher levels of off-hours monitoring by staff to ensure proper functioning would be necessary. In addition, increased levels of technical support to employers would be needed to assist them with electronic reporting problems.

In addition to the impact of the changes to employer reporting, implementation of Tier 3 will require extensive changes throughout the KPERS information technology system (KITS). Among the changes to KITS identified to this point are the following:

- Establishing eligibility for the new tier and enrollment of new members.
- Establishing an employer-annuity account for each member, including a service-based employer credit; variable interest credits and annuitization factors; and annuity formula.
- Establishing eligibility for the appropriate employee-annuity account plan types (401(a)/414(d)/414(k) plan vs. 403(b) plan).
- Developing new benefit estimate calculators for the new tier, both on KPERS' website and as part of the member web portal.
- Developing new annual reporting format and content for Tier 3 with the ability to populate the report from the database.
- Identifying and transferring Tier 1 and 2 nonvested members and vested legislators to Tier 3.
- Establishing a secure election mechanism for nonvested members to choose the account to which their Tier 1-2 contributions will be transferred, including calculators to assist members in making this selection based on their individual circumstances; establishing eligibility to make a selection; and capturing and permanently recording the selections or the default.
- Providing for the transfer of vested legislators and the present value of their accrued benefits.
- Changing the employer and member web portals reflecting the variances in plan design between tier 3 and Tiers 1-2.

Member Communication, Education, and Support

One of KPERS' fiduciary duties is to ensure clear, accurate, timely communications with members about the nature of their benefits and their rights and responsibilities under the plan. This duty would become even more critical with implementation of HB 2545/SB 338 as it involves fundamental changes in plan design affecting not only future members but a significant number of active members and placing additional responsibility on individual members.

In contrast to the current Tier 1 and 2 plan design, HB 2545/SB 338 would establish a multi-faceted plan design, thereby increasing the amount and complexity of information that must be communicated to members during implementation and on an ongoing basis. For example, KPERS will need to coordinate communication with members about naming beneficiaries for both the employer annuity account and the employee-directed account, as well as the manner in which qualified domestic relations orders would be processed for each component. Employees would need to complete two "retirement" or distribution processes. There would be different

requirements, options, documentation, and conditions for receipt of benefits from the employer annuity and employee-directed accounts.

Given these considerations, development of a comprehensive communication strategy would be a major focus of HB 2545/SB 338 implementation plans.

Implementation, Transition of Nonvested Members, and Elections. Throughout implementation of HB 2545/SB 338, communications would need to be targeted to multiple subsets of KPERS' membership. All active members would need to understand which aspects of Sub HB 2194 and HB 2545/SB 338 would be applicable to them and the implications of those changes. Particular care would be needed in communicating with nonvested members transferred to Tier 3. Those members will have a one-time, irrevocable choice to place their accumulated employee contributions and interest in either the employer-annuity account or the employee-directed account. The most beneficial option for a given member may be dependent on individual circumstances. Because the election will be irrevocable, the potential for appeals is widened if communications are not abundantly clear.

As a result, it will be necessary to provide approximately 53,000 nonvested members and 1,500 employers alike with clear, accessible communications about the available options and the irrevocable selection process, along with support to help answer their questions. Therefore, two major components of the projected cost to implement HB 2545/SB 338 are communications and member services staffing. Due to the short window for the benefit selections and the cost of providing in-person meetings, communications would be distributed primarily through print, electronic, and online media. However, in order to respond to increased contacts from members regarding their options, additional positions in Member Services would be necessary to support participating employers and active members with election and transition processes via telephone, e-mail, and KPERS web portals. This effect would be in addition to two other simultaneous elections for Tier 1 and Tier 2 members based on Sub HB 2194.

Ongoing Communications. KPERS would need to coordinate communication and education responsibilities with the third-party record keeper(s). In addition, KPERS will need to determine the extent to which KPERS member services staff should have access to current data on the employee-directed accounts. A significant portion of KPERS Tier 3 membership would participate in the 403(b) employee directed accounts, and the remainder would be in the 401(a)/414(d)/414(k) employee-directed accounts. This adds an additional level of complexity to both distribution and messaging. If multiple vendors are providing record-keeping services for the 403(b) plan, this coordination is required at multiple levels. Because the nature of the existing Tiers 1 and 2 defined benefit plan and the Tier 3 plan would be fundamentally different, communication and education should be more focused and directed to members by plan type. However, many employers currently have limited ability to segment communications with their employees by subgroups.

The benefits generated by the employer annuity account would be variable, depending not only on length of employment and future pay increases, but also on investment returns prior to retirement, age at retirement, and annuitization rates in effect at retirement. By their nature, benefits from the employee-directed account would be variable as well. Therefore, in order to more effectively

communicate with members about the extent to which they are on track to generate an adequate income replacement in retirement, Tier 3 members should be provided with consolidated annual statements and customized benefit estimate calculators that enable members to track and estimate benefits from both their employer annuity account and employee-directed account. A data feed from one or more third-party record keepers would be needed in order to include employee-directed account assets in annual statements.

Communication strategies during and following implementation of HB 2545/SB 338 would include printed and electronic materials, online videos, transition workshops in person and online, and increased telephone and e-mail support within Member Services. On an ongoing basis, it would be necessary to develop and maintain written and online materials and calculators for the more complex third tier, all of which would be in addition to updating and maintaining existing Tier 1 and 2 materials.

Employer Communication, Education, and Support

KPERS and participating employers work in close partnership in multiple arenas, including providing a primary conduit of communication and education for members and in carrying out business processes relating to all aspects of membership, contributions and reporting, and retirement processing. Therefore, a significant component of KPERS' education and communication strategies focuses on employers, and in particular, their designated agents. Any implementation plan for HB 2545/SB 338 would, of necessity, involve extensive communications and education for participating employers.

Primary communication with members. KPERS generally relies on employers' designated agents to disseminate information such as annual statements and newsletters. Introduction of a member web portal in 2009 provided the opportunity to direct information to members independent of their employer, but a significant number of members have not yet established their account, while others may not be consistent in checking it for new or urgent information. Employers are frequently limited in their ability to segment communications with their employees based on topic or group because the employer does not have access to such information (e.g., by plan, or by KPERS Tier 1 or 2 or by vested and nonvested members). Therefore, mass communications cannot be readily targeted to segments of the membership at this time.

Employers have traditionally been the primary contact with the member. Implementation of HB 2545/SB 338 would require coordination of the communication role among KPERS, the employer, and the third-party record keeper. KPERS would need to ensure that employers understand the new benefit structure, which employee groups will be part of Tier 3, and implementation plans, election processes, and the impact of the new plan design on member retirement planning so that they can provide positive and accurate information to members. In particular, employers will need to be able to assist employees with understanding the transfer of nonvested employees to the new tier and associated elections. On an ongoing basis, KPERS would need to work with the employee-directed account service provider to develop educational programs to help employers explain basic information about the account's features and the importance of saving for retirement.

Business process changes. During the transition period, KPERS would need to convey to employers detailed information about changes in reporting and transmitting contributions, including payroll system interfaces for transmitting detailed information electronically. As plan complexity increases, so does the need for employer education about a diverse range of operational issues, such as the following.

- Employers may need to separate contributions into two or more remittance processes for the blended Tier 1 through 3 plan contributions, and employee contributions to employee-directed accounts.
- Employers would need to complete two retirement processes for their employees.
- Procedures would need to be developed for handling members with multiple employers, multiple positions with the same employer, and multiple periods of employment.
- More complex reconciliation and auditing routines may be needed to identify and properly address exceptions (e.g., payroll errors resulting corresponding errors in contributions that then need to be backed out or added into employee-directed accounts).
- Identification and correction of exceptions becomes time-sensitive due to market gains or losses in employee-directed account assets prior to the adjustment. Standards would need to be established for how investment gains/losses are handled in connection with adjustments and responsibility for covering them.

Communication strategies during and following implementation of HB 2545/SB 338 would include printed and electronic materials, online videos, specialized workshops for designated agents both in person and online, and increased telephone and e-mail support.

Employee-Directed Accounts: Administrative Expense Funding Sources

Section 7 of HB 2545/SB 338 provides that administrative expenses associated with the employee-directed accounts may be funded through a combination of assessments of fees on employee-directed accounts; negotiated vendor reimbursements; an administrative expense rate paid by employers on active member compensation; fees charged to participants for to pay specific expenses attributable to that member; and employer contributions from members whose membership terminates and earnings on those contributions. Although the service provider contract(s) would cover many day-to-day operational responsibilities related to individual employee-directed accounts, the administrative and operation costs to KPERS for a range of plan management and oversight functions as described in this fiscal note would need to be funded. Expenses of the employee-directed accounts established under IRC 401(a)/414(d)/414(k) could be paid from assets of the KPERS or the funding sources in Section 7. However, the 403(b) plan expenses could not be paid from the KPERS Trust, and therefore, the funding provisions in Section 7 are the only funding sources for those accounts under HB 2545/SB 338. A separate account for paying 403(b) plan administrative expenses would need to be established.

In addition, major operational and contractual expenses would be incurred before implementation of the new Tier 3 plan, including the 403(b) plan component. Because the 403(b) plan will not be part of the KPERS Trust, a separate, appropriate source of funding for expenses incurred in implementing the 403(b) plan would need to be available during the planning and implementation period. KPERS' staff consulted its outside tax counsel, Ice Miller LLP, on the issue of funding a

new defined contribution plan's start-up costs without violating the Internal Revenue Code rules on using Trust Fund assets. According to tax counsel, the Legislature may provide funding by either appropriating state funds to pay for such costs or may authorize KPERS to establish an immediate employer surcharge to cover the 403(b) start-up costs. Because the 403(b) plan would primarily affect employers in the School Group, a related policy issue would be the source of funding for any employer surcharge – i.e., whether this additional surcharge would be funded from the State General Fund or out of other employer funding sources.

Effective Date of HB 2545/SB 338

The bill's effective date (July 1, 2013) and the January 1, 2014, implementation date of Tier 3 is not realistic, and the highly compressed timeframe will increase the costs associated with implementing HB 2545/SB 338. The range of legal, administrative, communication, contractual, and operational issues described in this fiscal note compound the risks associated with an overly aggressive implementation schedule and may jeopardize successful implementation of the plan as a whole.

- This plan design entails establishing both multiple plan components within 18 months. By way of contrast, previous bills provided a two-year implementation period for a straightforward defined contribution plan. Some aspects of the plan design are unique to Kansas, and therefore, no readily available, comprehensive examples of implementation strategies are available.
- The time and resources required to address each of the other major concerns described previously compounds the difficulties— e.g., multiple elections, IRS approvals, creation of an investment option for the defined contribution component based on the defined benefit portfolio, establishing multiple types of defined contribution plans for employee-directed accounts.
- The need for transitioning to positive reporting of pay and contributions by payroll period will have a major impact on KPERS and employers.
- The implementation would overlap with implementation of HB 2194 as well, which also entails significant resources for both KPERS and employers.
- KPERS will need to ensure that adequate resources are made available to members who are required to make elections under either Sub HB 2194 or HB 2545/SB 338. These elections are irrevocable and could have a major impact on their retirement income later in life. Therefore, adequate time must be provided to prepare and implement the election process, communications to employees and employers about the choices and their potential implications, and tools for members to estimate the impact of the options available.

A highly compressed implementation period would entail a number of major operational, fiscal, and fiduciary risks. KPERS' resources are already stretched thin, and so implementing both HB 2194 and HB 2545/SB 338 in a compressed timeframe would require rapid growth in staff and contractual services in very brief period of time, primarily in FY 2013. For these reasons, KPERS does not believe the effective date is achievable.

Beyond these practical considerations, KPERS' tax counsel has advised that the effective date throughout the bill should be based upon the receipt of a favorable determination letter from the

IRS for the new plan, plus an appropriate time for implementation. Currently, HB 2545/SB 338 provides for a two-year implementation period. Ice Miller LLP believes this implementation period should be applied after the IRS letter is received.

Staffing, Operating Expenditures, and Consultant/Professional Services

While concrete estimates are not currently available, it is clear that both temporary and permanent staffing increases would be needed throughout the agency in order to administer HB 2545/SB 338. An overview of the types of positions identified to date includes –

- Project management
- Defined contribution plan management and specialist staff
- Multimedia and publication writer staff
- IT network administration, applications development, and help desk staff
- Accountants
- Investment analyst staff
- Legal staff
- Employer and member education coordinators and representatives
- Benefit specialists and management

With the addition of multiple staff members, related expenses would include workspace and office equipment, including furniture, computers, phones, and additional copy and fax capabilities. Additional communications, postage, and office supply expenses would be expected, as well increased need for IT support and software license agreements. Staffing increases are expected to exceed KPERS' available office space. Expansion of KPERS' offices would result in reduced rental income from a portion of the 611 S Kansas Ave property currently leased to other state agencies.

Implementation of HB 2545/SB 338 would also require a range of consulting and professional services, including tax, legal, investment, defined contribution plan design and administration, accounting and auditing, and actuarial experts. Some amount of due diligence travel expenses should also be expected.

Technical or mechanical issues

KPERS is continuing to review HB 2545/SB 338 for technical or mechanical defects. Issues noted to date include the following:

- **Section 1(f).** The second sentence states that "no legal or contractual rights inure to the benefit of members" We believe that this means that members of the new plan do not have any rights under Tiers 1 and 2. We are concerned that this might be misread to mean that there are no benefits or contractual rights. Under federal law, members who have

reached their normal retirement age under the plan must have a non-forfeitable right to their accrued benefit under the plan. Therefore, this provision should be clarified.

- **Section 2(a)(7).** The definition of normal retirement age provides for a normal retirement age of 55 for "security officers," and is not consistent with existing provisions for correctional employees. Currently, there are two groups of correctional employees with lower normal retirement ages within Tier 1 and Tier 2. For Tier 2, Group A, which generally includes most corrections officers and their supervisors, can retire with full benefits at age 55 with 10 years of service, including at least three years in a Group A position immediately before retirement. Tier 2, Group B, which generally includes correctional institution employees who have regular contact with inmates (such as food service supervision), can retire with full benefits at age 60 with 10 years of service, including at least three years in a Group B position immediately before retirement. To retain a similar structure, a definition of security officer that covers both Correctional Member Groups A and B would need to be incorporated or referenced, with corresponding adjustments to the normal retirement age definition.
- **Section 3.** As currently drafted, Section 3 provides for the creation of a new 403(b) plan for "qualifying public school employees, community college employees and other eligible employees." Section 3 requires that this new plan must include "all plan options allowed under section 403(b) of the internal revenue code." Following is a list of the impacts of that provision. Clarification is needed to be sure that the intent is to include all of these provisions in this plan.
 1. The 403(b) plan would provide for investments in custodial accounts, individual annuity contracts, and group annuity contracts.
 2. The 403(b) plan would provide for employee elective deferrals and employer contributions, post-tax employee contributions, and Roth elective deferrals.
 3. The 403(b) plan would provide for loans, hardship distributions, and in-service distributions, in addition to lump sum distributions, periodic distributions, and annuities.There also is an incorrect reference in subsection 3 (line 21.) to Section 10. This reference should be to Section 9.
- **Section 5.** This section provides that "each participating employer shall make a mandatory contribution of 6% of an eligible employee's compensation to the 403(b) plan for participants in such plan." This sentence is very unclear. We believe that the purpose is to make a mandatory 6% contribution by salary reduction from each employee's compensation. We would suggest that the sentence be re-written to make this clear.
- **Section 6(a).** The second sentence is problematic. It states:

"For qualifying public school employees, community college employees and other eligible employees, such investment alternatives shall include, but not be limited to, investment alternatives as allowed under section 403(b) of the federal internal revenue code." In order to be in compliance with federal law, the investments under the 403(b) plan must be limited to what is authorized for a 403(b) plan, while the 401(a) plan benefits must follow the 401(a) rules.
- **Section 11** This section is confusing to us because it appears that two interest credits will be applied at the end of each calendar year – 0% and the supplemental interest credit rate (which could be positive or negative). What will be reported to the member? Will the member receive a statement that shows 0% or the supplemental interest credit rate? Will the member see two accounts? This section (third sentence) also seems to require a calculation of net

return on virtually any day a member retires. That could be very expensive. Two alternatives would be to credit no net return in the partial year or to use the last year's net return for the partial year. KPERS' tax counsel is not aware of any other plan that has this structure.

- **Section 16.** In order to calculate a present value of accrued benefits for vested legislators under Section 18, an interest rate and mortality table would be needed. In addition, a retirement age assumption is necessary because vested legislators may be active members who could continue working for a period of time. However, Section 16 states that the terms "actuarial equivalent" and "actuarial computation" in the existing retirement act do not apply under HB 2545/SB 338. Those terms are necessary to establish a framework for setting the interest rate, mortality table, and retirement age assumption used in the present value calculation. Therefore, those terms will either need to be defined in HB 2545/SB 338 or the existing definitions applied to it in order to carry out Section 18.
- **Section 18.** The provisions for converting the benefits already earned by vested legislator's to their present value does not distinguish between benefits earned due to service as a legislator versus benefits earned on the basis of other public service – such as service as a teacher. Further evaluation as to how these accrued benefits could be distinguished would be required.
- **Section 18.** The description of the present value calculation benefits already earned by vested legislators states that the amount to be transferred is "the present value of such vested retirement benefit, including all employee and employer contributions, earned before January 1, 2014, converted to a lump sum amount." A present value calculation is, by its very nature, a lump sum amount. In addition, the employee and employer contributions would not used in a present value calculation. The determination of accrued benefit is based on the formula "Years of service X final average salary X 1.75% multiplier," not on contributions. Moreover, there are no employer contributions that are attributable to an individual member. Therefore, references to contributions and conversions to a lump sum should be deleted, and an additional provision providing for the lump sum to be no less than the employee contributions plus interest should be added.
- **Section 23.** There is an incorrect reference to K.S.A. 74-4919d in Section 23's list of repealed sections.

In addition to these technical issues, KPERS has identified a number of more detailed policy issue details and areas requiring clarification that would need to be addressed if the current plan design progresses. For example, Tier 1 and Tier members have the option of selecting one of three "life-certain" options along with several joint-survivor options? You may wish to consider adding similar life-certain options for Tier 3, along with the joint-survivor options provided in HB 2545/SB 338. As the legislature continues refining the proposed plan design, KPERS will assist with identifying these issues.