

February 13, 2012

The Honorable Stephen Morris, Chairperson
Senate Committee on KPERS Select
Statehouse, Room 333-E
Topeka, Kansas 66612

Dear Senator Morris:

SUBJECT: Fiscal Note for SB 338 by Senate KPERS Select Committee

In accordance with KSA 75-3715a, the following fiscal note concerning SB 338 is respectfully submitted to your committee.

SB 338 would incorporate the recommendations of the KPERS Study Commission as required by 2011 Senate Substitute for HB 2194. SB 338 would establish a new KPERS plan design, eliminate the statutory cap on annual increases in employer contribution rates, and eliminate certain service credit purchases. The bill as a whole would take effect July 1, 2013, with some variation in implementation dates for each of the three components of the bill. The bill would be known as the “Kansas Public Employees Retirement System Act of 2014.” None of the changes in this bill have any effect on current KPERS retirees.

New Plan Design

SB 338 would establish a new tier of employees in KPERS, referred to as Tier 3, as of January 1, 2014. The new plan design would consist of two elements for each member of the new tier. An “employee-directed account” would receive employee contributions of 6.0 percent of the employee’s salary to a defined contribution (DC) plan, and an “employer annuity account,” with employer contributions, based on the employee’s years of service, to a cash-balance plan that pays a lifetime annuity benefit at retirement.

Tier 3 membership would consist of the following employees:

1. Any member first hired on or after January 1, 2014;
2. Any active or inactive Tier 1 or Tier 2 member who is not vested on January 1, 2014, including legislators; and
3. Any legislator vested in Tier 1 or 2 as of July 1, 2013.

Employer Annuity Account

All employer credits would be applied to the “employer annuity account.” The employer credit would vary by years of service, beginning at 1.0 percent of the employee’s salary for the first year of service, and increasing by 0.5 percentage points for each year of service, up to a maximum of 5.0 percent by year nine. Any credited service accrued by a member under the provisions of the pre-2014 plan (Tier 1 or Tier 2) is to be credited for the purpose of computing the years of service for determining employer credits.

The employer annuity account component of the plan would be a cash balance plan, which is considered by the IRS to be a defined benefit plan. The employer credit applied to the member’s notational employer annuity account is not the employer contribution. Because the employer annuity account would be a defined benefit plan, the account would be part of the KPERS trust, and its assets would be managed as part of the existing KPERS portfolio. Employer contributions for Tier 3 members would be actuarially determined through the annual valuation process and blended in with the employer contributions for Tier 1 and Tier 2 members so that employers would pay a single rate for all members, regardless of tier. The blended employer contribution rate would include any payment on the unfunded actuarial liability.

Members would have a forfeitable vested benefit after completing five years of service. Normal retirement age would be age 65, except that for security officers, normal retirement age would be age 55. The KPERS Board of Trustees would annually credit each employer’s annuity account with a zero percent interest credit, as well as a “supplemental interest credit rate” equal to the net investment return on the KPERS portfolio, whether negative or positive in that particular calendar year. An additional supplemental interest credit would be provided when a member retires “in the middle of a calendar year,” which is to be equal to the net investment return on the KPERS portfolio for that portion of the calendar year. For purposes of calculating the member’s annuity benefit at retirement, the member’s employer annuity account could not be lower than the total amount of employer contribution credits to the account.

Members who are not vested upon terminating plan membership would forfeit all employer contributions and interest credits. Active and inactive members who would be vested but die prior to reaching normal retirement age would also forfeit the employer annuity account and interest credits. However, if the member would have ten or more years of service at death and has designated the member’s spouse as the member’s sole primary beneficiary, the member’s surviving spouse would be eligible to receive an annuity on and after the date the member would have attained normal retirement age had the member survived.

Upon reaching normal retirement age and the completion of five years of service, the member’s benefit could not be forfeited, and the member would be eligible to receive the benefit at any time after termination from service. The benefit for the member would be determined by the conversion of the value in the employer annuity account to a single life annuity with five-year certain payments. The annuity would be determined using factors established by the KPERS Board, based on the Pension Benefits Guaranty Corporation’s distress termination

interest rates. Among other factors, the Board would need to select a mortality table to be used for this conversion. With this form of an annuity, the member would receive a lifetime benefit, and if the member would die within the first five years following retirement, the member's beneficiary would receive the benefit for the remainder of the five-year period. However, the member would also have the option of electing any joint and survivor option available to Tier 1 and Tier 2 members. There would not be any option for a lump sum distribution, except as outlined for small balance accounts.

If a member's vested employer annuity account is less than \$1,000 at the time of separation from service, the account balance must be distributed to the member in accordance with applicable Internal Revenue Code (IRC) provisions. The member may choose to receive the distribution directly or through a direct rollover to an eligible retirement plan, with a direct payment as the default in the case of members who do not make an election.

Employee-Directed Account

The Board would establish two types of employee-directed accounts: a "403(b) plan" would 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 IRC section 403(b). KPERS notes that further analysis would 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 would establish a separate account for each 403(b) member, which would be administered in accordance with section 403(b). For all other members, a DC plan component would 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 would be held in the existing KPERS Trust. The Board would establish a separate account for each member, which would be administered in the nature of a defined contribution plan, as provided by section 414(k).

A mandatory employee contribution equal to 6.0 percent 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 would contribute the 6.0 percent mandatory contribution, up to the maximum amount allowed by the IRC. KPERS notes that, while the 6.0 percent contribution is characterized as an employer contribution, KPERS assumes it would not represent an additional 6.0 percent of compensation beyond the service-based contributions to the employer annuity account, but would be a mandatory salary reduction contribution under section 403(b). Because these accounts would be established under a separate plan, they would not be held within the existing KPERS Trust.

Eligible employees in the 403(b) plan could make 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 would contribute the mandatory 6.0 percent of compensation, up to the maximum amount allowed by the IRC. These contributions would be picked up by the employer through a salary reduction, as provided by section 414(h)(2) of the

IRC. No additional discretionary contributions to the employee-directed account would be permitted. In addition, the Board would accept the rollover of contributions and income from another eligible retirement plan to a rollover account established for each member in conjunction with the member's employee-directed account.

The KPERS Board would establish a "wide range of investment alternatives" for the employee-directed accounts. The 403(b) plan would "include all plan options as allowed under section 403(b), and such investment alternatives are to include, but not be limited to, investment alternatives as allowed under IRC 403(b)." For all employees, the Board would offer an investment alternative that is similar to the investment portfolio of KPERS. This fund would be designated as the default investment for any member or beneficiary who does not select one or more investment options. The Board would review the suitability and management of the investment alternatives and may make changes in the alternatives offered.

Members vest immediately in the contributions and investment gains and losses in their employee-directed account. Those assets are not subject to the normal retirement age established for the employer annuity account, and would be portable at termination, subject to IRS requirements regarding distributions. Distributions may be in the form of a direct rollover to an eligible retirement plan, a lump-sum distribution, or an optional form of periodic distribution offered by the Board.

Transfer of Non-Vested Members

Tier 1 and Tier 2 members who have not vested as of January 1, 2014, would move to Tier 3, effective on that date. Their Tier 1 or 2 member contributions, plus interest, would be transferred. It is estimated that approximately \$225.0 million in nonvested member contributions and interest would be transferred to Tier 3. Subject to receipt of IRS approval, beginning July 1, 2013, nonvested KPERS members would be given a chance to make an irrevocable election to have their transferred member contributions credited to the employee-directed account or the employer annuity account or some combination of the two. The employee-directed account would be the default for those who fail to make an election or in the event IRS approval is not received.

Legislators

All legislators (nonvested and vested) would move to the new Tier 3 plan and have the same benefits as other employees. Rather than a transfer of their member contributions, plus interest, those legislators who are vested would receive the present value of their vested retirement benefit, earned before January 1, 2014. This amount, which is estimated to be approximately \$22.0 million in total, would be transferred to the employer annuity account of the member. The present value of their accrued benefits credited to their employer annuity account would remain within the KPERS Trust and would not represent a distribution to the member.

Effective January 1, 2014, legislative compensation would no longer be “annualized.” Contributions and benefits earned on and after January 1, 2014, would be calculated based only on per diem compensation during a regular or special session; per diem compensation for attendance at certain in-state or out-of-state meetings; additional compensation for legislative officers; and any other additional compensation provided by law other than expense allowances or reimbursements.

Death and Disability Plan

SB 338 would extend the state’s current death and disability plan coverage to Tier 3 members, subject to a series of provisions set out in the bill. Under current law, the KPERS Board has the authority to establish a plan of death and long-term disability benefits. In general terms, the death and disability plan established by the Board provides a disability income benefit equal to 60.0 percent of annual salary, offset by Social Security benefits. This disability benefit remains in place so long as the individual remains disabled under the terms of the plan, until the earlier of either age 65 or retirement, for those who become disabled before age 60; or five years after the disability benefit begins or retirement, for those first disabled at age 60 or later.

Active members who die receive an insured death benefit equal to 150.0 percent of annual salary, for deaths that are not connected to service. Employers pay the employer death and disability rate to fund these benefits. Current law sets that rate at 1.0 percent of the amount of compensation on which KPERS contributions are based.

Current law also provides certain retirement benefits for members who are on long-term disability. SB 338 sets out the following provisions with respect to the retirement benefits for Tier 3 members who are receiving long-term disability benefits. The member would receive service credit for the entire period of the disability. The member’s employer-annuity account would be credited for the entire period of disability with the credits and interest prescribed by SB 338. KPERS would assume that an amount equal to the service-based employer credit for an active member with the same years of service would be credited to the employer annuity account. The salary on which the credits are based would be the member’s pay at the beginning of the disability, adjusted after five years for the lesser of the increase in the CPI for urban consumers, minus 1.0 percent, or 4.0 percent each year. All credits to the employer annuity account would cease as of the earliest of the member’s normal retirement age, death, or the date the member is no longer entitled to receive disability benefits.

The employer credits to the employer annuity accounts of Tier 3 members on long-term disability would be funded in the same manner as employer credits for active members. As noted previously, the employer credit would not be a direct employer contribution. The actuarially determined employer contribution rate paid on the payroll for active KPERS members in all three tiers would be calculated in a manner that would fund the employer credits of members on long-term disability as well.

Administrative Provisions

The KPERS Board would administer the KPERS Act of 2014 in the same manner as it administers existing law, except as specifically provided in SB 338. The Board could contract for plan administrative services using a competitive proposal process when contracting for consulting, educational, investment, recordkeeping or other administrative services. With respect to the employee-directed accounts, the Board would be authorized to fund administrative expenses of the accounts through several mechanisms. Forfeitures of the employer annuity accounts are to be used to pay administrative expenses of those accounts or to reduce employer contributions.

Eliminate Statutory Cap on Increasing Employer Contribution Rates

Under existing law, the annual increase in KPERS employer contribution rates is limited to 0.6 percentage points per year. Upon completion of the “trigger mechanism” in 2011 Senate Substitute for HB 2194, the employer contribution cap will increase over a period of four years, beginning in FY 2014 for the State and School Groups (CY 2014 for the Local Group). For FY 2014 (CY 2014 for the Local Group), the statutory cap will increase to 0.9 percent, rising each subsequent year by 0.1 percent to a 1.2 percent cap beginning FY 2017 (CY 2017 for the Local Group) and subsequent years. However, SB 338 would entirely remove the statutory cap, as of the bill’s effective date. As a result, beginning in FY 2014 for the State-School Group and CY 2014 for the Local Group, the employer contribution rate would rise to the actuarially required contribution (ARC) rate.

Eliminate Service Credit Purchases

As of July 1, 2013, SB 338 would repeal a number of statutory provisions authorizing members to purchase various types of service credit. The bill would eliminate the option for KPERS members to purchase service credits, other than purchase of participating and prior service credit that was forfeited upon separation from service and withdrawal of contributions.

State-School Group

Enactment of SB 338 would increase KPERS employer contributions at a faster pace than under the existing 0.6 percent cap, or with the increases in 2011 Senate Substitute for HB 2194. According to the KPERS actuary, the total employer contributions from FY 2012 through FY 2060 for the State-School Group would total \$22,140.9 million with 2011 Senate Substitute for HB 2194. With the enactment of SB 338, total State-School Group employer contributions would total \$33,039.1 million, which would result in \$10,898.2 million in additional contributions, of which approximately 75.0 percent would be from the State General Fund.

Enactment of SB 338 would increase employer costs for future benefits. According to KPERS, 2011 Senate Substitute for HB 2194 would have employer costs for future benefits, also known as the employer normal cost, decline to between 0.50 percent and 0.75 percent of payroll,

with an 8.0 percent investment return assumption. With SB 338, the employer normal cost would be between 2.5 percent and 3.0 percent of payroll, with an 8.0 percent investment return assumption. KPERS estimates that the total normal cost payments from FY 2012 through FY 2060 would be \$6,553.7 million under 2011 Senate Substitute for HB 2194. Enactment of SB 338 would have the normal cost payments total \$18,354.9 million, an \$11,801.2 million increase, of which approximately 75.0 percent would be from the State General Fund.

KPERS notes that it is difficult to compare the costs between the two bills, as actual benefits ultimately paid to members would vary with SB 338, depending on actual member investment experience. Benefits paid under the existing defined benefit plan, as modified by 2011 Senate Substitute for HB 2194, would be solely dependent on the number of years of service and final average salary at retirement.

Higher employer contributions to fund the State-School Group unfunded actuarial liability (UAL) would be paid more quickly with SB 338 than with Senate Substitute for HB 2194. With the full payment of the ARC rate beginning in FY 2014, future growth of the UAL would be expected to peak at a lower level and decline sooner than with 2011 Senate Substitute for HB 2194. KPERS estimates that UAL payments under 2011 Senate Substitute for HB 2194 would total \$15,587.3 million from FY 2012 through FY 2060. With enactment of SB 338, these payments are estimated to total \$14,684.2 million, or a reduction of \$903.1 million. For modeling employer contributions, KPERS notes that the UAL would be assumed to be reamortized to an open ten-year period in 2030 to limit the effect between the valuation dates of the system and the fiscal year in which rates determined by the valuation take place.

In addition to the long-term fiscal effect on the KPERS System, enactment of SB 338 would likely increase the total cost of death and disability benefits, as there would be an increase in the normal retirement age. With SB 338, new hires and non-vested members transferred to Tier 3 would have a normal retirement age of 65, while the current Tier 1 and Tier 2 would provide the option for full retirement at younger ages. For example, Tier 1 and Tier 2 members could retire at age 62, with 10 years of service, or according to the Rule of 85 (age + service = 85) for Tier 1 members and at age 60 with 30 years of service for Tier 2 members. Tier 1 and Tier 2 also provide early retirement options, which would not be available under Tier 3. The availability of full or early retirement before the age of 65 currently provides the opportunity for members on disability benefits to move to a retirement benefit more quickly than would be possible under Tier 3. As a result, many long-term disability claims now end between ages 60 and 65 as individuals elect to retire and receive that benefit instead. If that pattern of retirement prior to age 65 would shift under the new plan, the cost of the death and disability plan would increase. However, the extent of that cost impact has not yet been modeled by the actuary.

Local Group

Enactment of SB 338 would increase KPERS local employer contributions at a faster pace than under the existing 0.6 percent cap, or with the increases in 2011 Senate Substitute for HB 2194. According to the KPERS actuary, the total employer contributions from FY 2012

through FY 2060 for the Local Group would total \$5,744.6 million with 2011 Senate Substitute for HB 2194. With the enactment of SB 338, total State-School Group employer contributions would total \$9,437.8 million, which would result in \$3,693.2 million in additional contributions.

Enactment of SB 338 would increase Local Group employer costs for future benefits. KPERS estimates that the total normal cost payments from FY 2012 through FY 2060 would be \$1,913.0 million under 2011 Senate Substitute for HB 2194. Enactment of SB 338 would have the normal cost payments total \$5,917.9 million, a \$4,004.9 million increase.

Higher employer contributions to fund the Local Group unfunded actuarial liability (UAL) would be paid more quickly with SB 338 than with Senate Substitute for HB 2194. KPERS estimates that UAL payments under 2011 Senate Substitute for HB 2194 would total \$3,831.6 million from FY 2012 through FY 2060. With enactment of SB 338, these payments are estimated to total \$3,519.9 million, or a reduction of \$311.7 million. For modeling employer contributions, KPERS notes that the UAL would be assumed to be reamortized to an open ten-year period in 2030 to limit the effect between the valuation dates of the system and the fiscal year in which rates determined by the valuation take place.

Elimination of Service Credit Purchases

Although KPERS indicates that the elimination of service credit purchases would not affect the long-term funding status of the system, the agency would anticipate a spike in the number of purchases during FY 2013. Members who would be eligible for service purchases would likely take advantage of the opportunity for service credit purchase prior to the effective date of the act, particularly among nonvested members who could vest prior to January 1, 2014 with a service purchase. KPERS states that temporary staff would be needed to help with this short-term increase in workload. However, no cost estimate for this aspect of the bill is presented by the agency.

Administrative Expenses

KPERS indicates that enactment of SB 338 would have significant administrative costs for the agency. However, the agency does not have an estimate of the total expenditures that would be required. However, KPERS notes that the following new permanent positions would be needed on a temporary and/or permanent basis: project management, defined contribution plan management and special staff, multimedia and communication staff, IT network administration staff, accountants, investment analysts, legal staff, employer and member education coordinators and representatives, and benefit specialists.

Major expenditures would also be required for modifications to the agency's information systems; expansion of KPERS' information systems and hardware resources, including its web portal capabilities; expanded data storage and disaster recovery; contractual services for tax counsel, defined contribution investment and plan administration consultants, and actuarial and auditing services; due diligence travel; and communications with members and employers

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regarding plan design changes and elections through a range of printed and online materials, videos, calculators, mailings and in-person and on-line workshops; telephone and e-mail support.

With the need of additional staff, 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 would be expected to exceed KPERS' current available office space. Expansion of the office would result in reduced rental income from a portion of the property currently leased to other state agencies that would have to be displaced. Any fiscal effect associated with SB 338 is not reflected in *The FY 2013 Governor's Budget Report*.

Sincerely,

A handwritten signature in black ink, appearing to read "Steven J. Anderson", with a long horizontal flourish extending to the right.

Steven J. Anderson, CPA, MBA
Director of the Budget

cc: Faith Loretto, KPERS