TESTIMONY TO HOUSE PENSIONS & BENEFITS COMMITTEE

Submitted by: Rebecca Proctor, Member of KPERS Study Commission

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Mr. Chairman and members of the Committee: Thank you for giving me the opportunity to appear before you today. My name is Rebecca Proctor. I am a labor and employee benefits attorney and served on the KPERS Study Commission. I know you have heard from Alan Conroy and others about the cash balance plan passed last session. I appear before you today to provide information about the KPERS Study Commission and the journey that brought the Legislature to the cash balance solution.

THE KPERS STUDY COMMISSION

Legislation establishing the KPERS Study Commission was passed during the 2010-2011 legislative session. The Study Commission was a thirteen-member panel, and included both legislators and individuals appointed from the public. The Study Commission's charge was to study the advantages and disadvantages of implementing alternative retirement plans, including a defined contribution plan and a hybrid plan, as well as other plan options. We were additionally charged to "develop a viable plan to ensure the long-term sustainability of the system."

The Study Commission met two days per month, from July to December, 2011. During those meetings, we heard background testimony about how the current KEPRS system functioned and how the unfunded actuarial liability arose. We heard testimony from financial service providers, officials from other states, benefit attorneys, and other interested parties about different types of retirement plans. We heard testimony from employees, retired employees, and labor groups about how changes to the KPERS system would impact employees.

We also received briefings on the various public policy issues that must be considered when making changes to a public employee retirement plan. In the private sector, an employer has no responsibility for an employee following separation from service, so private employers do not have to worry about the sufficiency of a retirement benefit. However, in the public sector at the state level, employees who retire without a sufficient benefit can end up on the public assistance roles. We were advised to weigh the costs and benefits of the plans we considered.

This involved some literal cost benefit analysis: What does the proposed plan cost versus the retirement benefit it provides? We were also advised to consider how changing the retirement benefit would impact the ability of the state (and of any political subdivision participating in KPERS) to attract workers. For perspective, a February 2011 study by the Bureau of Economic Analysis ranked Kansas 49th amongst the states in total compensation (wages + benefits). Kansas is one of only nine states where total compensation for public employees is below total compensation for private sector employees working in the state.

After hearing all of the testimony, we were asked to narrow the focus and select two specific plan types for further study. By majority vote, we selected the defined contribution plan and the hybrid stacked plan.

DEFINED CONTRIBUTION PLANS AND HYBRID STACKED PLANS

Defined contribution plans are pretty straightforward. What is set or defined is the amount of money that goes into the plan (via both employee and employer contributions). Each employee has an individual account, and is responsible for directing the investment of his/her individual account among the investment options provided by the plan. The investments are subject to market, with the employee enjoying any gains or suffering any losses. Defined contribution plans do not guarantee any sort of benefit at retirement, and completely remove any risk of loss from the employer.

The hybrid stacked plan combines a traditional defined benefit system (such as the current KPERS plan) with a defined contribution component. Under a traditional defined benefit plan, what is defined or set is the benefit paid at retirement. The benefit is calculated using a formula that usually includes years of service, age at retirement, and final average salary. The way a hybrid stack works, is that all employees earn a traditional defined benefit pension on salary earnings up to a specific, set cap. Employees earning more than the cap also contribute in a defined contribution plan, with contributions to the defined contribution plan being based on only the salary amount over the cap. This plan protects all workers from some risk of loss by guaranteeing a benefit at retirement. Lower wage workers are completely protected. Higher wage workers share the risk of loss on the upper portion of their earnings by controlling their own investments.

Once we selected these two types of plans for more in-depth study, we received input on both from KPERS and from the KPERS actuary. We were given the opportunity to have the KPERS actuary present over several days of meetings. The actuary brought with her a computer modeling tool that allowed us to see, in real time, how changes would impact the KPERS system. We were able to see the result of proposed changes on the unfunded liability, on the plan's normal cost, on the retirement benefit, etc. Please understand that the actuary never independently presented any sort of retirement plans for our consideration. She only analyzed and modeled the various approaches we asked to see. We also received a very thorough memo from KPERS explaining what KPERS believed were the costs, benefits, and challenges of both plan types.

We learned a couple of important things through all of this modeling. First, we learned that meaningful reduction in the unfunded liability becomes more difficult if employees and contributions are moved out of the defined benefit plan. Defined benefit plans like KPERS are generally invested for the long-term, because the plan is considered to continue indefinitely with no set end date. This is why KPERS has managed to average 8% earnings, because it can invest in a range and mix of investments that would not be appropriate for an individual investor. If the plan were closed to new participants (as it would be if all new hires were moved to a defined contribution plan), the plan would suddenly have an end date and the investment mix would have to change. This would generally result in more conservative investments with lower expected returns.

Second, we learned that if you look at overall plan costs outside of the unfunded liability, defined contribution plans are inherently more expensive than defined benefit plans. These increased costs apply whether the defined contribution plan is the only retirement plan or whether it is added as part of a hybrid approach. With a defined contribution plan, the employee has a self-directed, individual account. The employee bears the risk of any loss, but also reaps the benefit of any gain. So, the employer contribution is never offset by the plan's earnings. If the employer contribution is 5%, the employer is always on the hook for that 5%.

By contrast, a defined benefit plan has no individual accounts. All of the money is pooled together, in a trust, for investment purposes. Any earnings stay with the trust and can be used to offset the employer contribution. When we looked at the actuary's models, after the UAL is paid off, the State's funding obligation under a defined benefit plan drops to around 1%. With a defined contribution plan, the funding obligation always remains at whatever contribution level is set. Because accounts are self-directed, the increase in cost does not necessarily come with an increased benefit. Returns are determined based on how the employee chooses to invest the money. An 8% return, like the current defined benefit plan earns, is generally only achieved by aggressive investors with high risk tolerance. The average return a conservative investor might expect is about 4%.

Additionally, KPERS as currently run has an administrative cost per member of $44. For comparison, a peer average from other plans is $90 per member. Data received from other states showed a defined contribution plan cost per member of $92. Related to this point, we learned from KPERS that changing the system away from a defined benefit plan to a defined contribution plan would require all 1,500 KPERS contributing employers to make changes to their payroll and accounting systems, something about which we had received no testimony or cost data. KPERS itself would also have to enhance and change its information technology systems, which is another issue we had not considered nor had costed out.

Third, we learned that with our current level of unfunded liability there is no perfect and magic solution. The unfunded liability is a debt the state owes and has to pay. There is not a quick, easy, or painless way to pay that debt.

Finally, we learned that, despite months of study, we had not considered all relevant and necessary facts and did not have sufficient time to create a fully fleshed-out plan. That task fell to our legislative members and their colleagues.

THE CASH BALANCE PLAN

A group of legislators from both parties, including Chairman Johnson and Representative Kelly, worked together to use the Study Commission's learnings to develop a plan that could address the UAL and provide a reasonable retirement benefit without a long-term sustained increase in operating costs. The result was the cash balance plan. So where did it come from?

During its meetings, the Study Commission received testimony about cash balance plans from Nebraska. Nebraska ran a defined contribution plan from 1967 through 2002. Because of concern about the costs of the defined contribution plan versus the benefit provided, Nebraska determined to convert its defined contribution plan to a cash balance plan. Since Nebraska converted in 2002, its cash balance plan went through the economic downturn and provided a sample of how cash balance plans respond to difficult economic times.

The Study Commission had not selected cash balance plans for further study. However, in light of the increased costs associated with implementing a defined benefit plan (either by itself or as a part of a hybrid stack), the Study Commission's legislative members decided to look for other approaches and determined the cash balance approach might be worth a second look. Representatives from the Nebraska plan and others were invited to provide information to the joint committee. The KPERS actuary brought the computer modeling tool and modeled the cash balance approach for the joint committee. After looking at all of the relevant data, the legislature ultimately passed the cash balance approach.

CONCLUSION

I know you have received at lot of information about the cash balance plan, so I will not cover its provisions. However, I do think it is important to note this fact: no one, either on the Study Commission or in either political party, started this process advocating for a cash balance plan. Yet, despite having no strong advocate, the cash balance plan emerged as the best solution for a very difficult situation. Thank you for your time and attention.