BEFORE THE HOUSE COMMITTEE
ON PENSIONS AND BENEFITS
OPPOSITION TESTIMONY REGARDING THE KPERS BILL

Submitted by: Rebecca Proctor, Member of KPERS Study Commission
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Mr. Chairman and Members of the Committee: Thank you for allowing me to speak to you today. As you may recall, my name is Rebecca Proctor. I am an attorney specializing in labor law and employee benefits law. I addressed you earlier this session regarding the KPERS Study Commission's process and conclusions. I appear before you today to testify in opposition to making any hasty plan design changes this session.

EVER-CHANGING PROPOSALS

I want to begin by saying it was extremely difficult to determine what points to address today. That difficulty comes from the fact that throughout this session, there has been no clear picture of what precisely is being proposed. First, Budget Director Anderson provided this committee with a general justification of why defined contribution plans are good. I prepared remarks, which I shared with you, regarding why defined contribution plans are not the best option for our state.

Then, representatives from Dimensional Advisors were here to discuss the superiority of a managed defined contribution approach. Following the managed defined contribution presentation on Monday, I began drafting remarks on managed defined contribution. Then the bill was issued.

This bill is basically last session's Senate Bill 338 (the Study Commission bill) with a few minor revisions. I would like to remind you that last year's legislature rejected that similar plan, primarily because it increased costs while failing to address the UAL. Just as the plan was introduced at the tail-end of the Study Commission's meetings in 2011, it is being introduced at the very end of this legislative session. In both cases, there was little time for a thorough analysis. Luckily for both the Study Commission and this legislature, last year's legislature received the plan at the beginning of session and was able to give it the attention it deserved. After thorough debate, discussion, and analysis, it was decided this type of plan was not the right solution for our state. Since there was a very similar bill last year, all of you should ask why, if it is such a good solution, it was not provided to you in full written form until this week when time is short and discussion limited. I urge you to follow the previous legislature's lead and reject this bill.

WHAT THE BILL DOES

I want to walk through a few key provisions in the bill and the issues with each.

Two Types of Accounts—Cash Balance and Defined Contribution

For all new employees hired on or after 1/1/2015, or all prior employees who withdrew their KPERS balance and then return to employment 1/1/2015 or after, two accounts are established: a retirement annuity account (or the cash balance plan) to receive employer contributions, and an employee-directed account to receive employee contributions.

Public School and Community College Employees are Treated Differently

As drafted, the bill requires two separate types of employee-directed accounts. For qualifying public school employees and community college employees, the employee-directed defined contribution account will be a 403(b) plan. For all other employees, the employee-directed account will be a 414(k) plan. Employees in the 403(b) plan may make elective deferrals in addition to the required contribution; employees in the 414(k) plan may not.

403(b) Plans

A 403(b) plan is also known as a tax-sheltered annuity. Only employees of public schools, employees of non-profit organizations, and some ministers may participate in 403(b) plans. IRS publication #571 contains details of 403(b) plans for any of you interested in additional reading on the subject. 403(b) plans are limited to investing in annuities (either fixed or variable) or in mutual funds in custodial accounts with a registered investment company. With a 403(b) plan, employees will not have the wide range of investment alternatives usually available under say a 401(k) private sector plan.

Of note here is the fact that annuity contracts have their own terms and conditions. Let's say for example a public school employee invests in an annuity contract. Then, the KPERS board decides to change investment providers and no longer use the provider through which the employee invested in the contract. The money the public school employee invested would not automatically move when the plan changed investment providers. Each participant investing in an annuity contract would have to individually move the money to a new provider.

KPERS will provide 403(b) options from three or more annuity or investment providers. The bill also requires public school and community college employers to use all reasonable efforts to also make available at least three additional annuity or investment providers. Because both KPERS and the employer will provide investment options, there will be no real centralized oversight for employees in the 403(b) plan.

After repeatedly reading the bill, I am somewhat confused how contributions to the 403(b) plan will work. In Section 7(a) on page 8, the bill states, "for participants in the 403(b) plan, up to the amount allowed by the internal revenue code, each participating employer shall make a mandatory contribution of 6%." This is at odds with the language earlier in the bill which states the employee-directed accounts will receive employee contributions. Given this provision, it is unclear whether public school employees will be participating in both the cash balance and the 403(b) plan, or just the 403(b) plan.

414(k) Plans

A 414(k) plan is type of defined benefit plan that provides a benefit derived from employer contributions based partly on the balance of a separate account of a participant. In other words, it allows a plan to have individual accounts combined with a defined benefit plan. In practice, these accounts give participants the ability to transfer their benefit from a defined benefit plan and convert it to a defined contribution account within the same plan. The mandatory employee contribution to the plan is 6%. As referenced above, no additional elective deferrals are allowed.

Default investment Option

The default investment option for employees who do not make an allocation will be similar to the KPERS portfolio. This sounds great in theory, as the KPERS portfolio has a strong track record. However, it ignores the requirements for a default investment option. A default option must be appropriate for any participant, at any lifestage. As I am sure you have heard many times this session, the KPERS portfolio is invested with the assumption that the plan exists in perpetuity and has no hard and fast end date. That type of portfolio is not appropriate for all investors, because individual accounts do not exist in perpetuity.

Changed Guaranteed Interest Rate and Annuitization Rate

The cash balance portion of the plan is a cash balance plan with a 5% guaranteed interest rate and a 5% initial annuitization rate (as opposed to the 5.25% guaranteed rate under the existing plan and the 6% initial annuitization rate). This bill does not indicate it alters existing employer contribution rates. If they remain the same as the current cash balance plan, the employer contribution is 3% in years 1-4, 4% in years 5-11, 5% in years 12-23, and 6% for 24 plus years.

The annuitization rate makes a big difference in the retirement benefit. When the KPERS actuary, Ms. Beckham, modeled the similar plan that was presented last year, she had a graph that illustrated the importance of the annuitization rate. Using her example, if a $300,000 account balance is converted to a monthly annuity for a 65-year old, a 3.5% interest rate will result in around a $1700.00 monthly annuity; if the interest rate is 6.5%, the monthly

benefit changes to around $2400.00. It is extremely disturbing that you as a committee are being asked to make these changes without having the opportunity to see them modeled by the plan actuary.

THE PLAN INCREASES COSTS WITHOUT ADDRESSING THE UAL

Last week you received a cost study performed by Ms. Beckham showing that a plan of this type is more expensive than the current cash balance plan. Additionally, this plan not only contains no provisions to address the UAL, but also hurts the State's ability to pay the UAL. The rationale for implementing the cash balance plan was, in part, that earnings about the guaranteed interest rate could be used towards paying down the UAL. Under the current cash balance plan, all contributions (both employee and employer) go into the cash balance plan. All of the projections for paying the UAL down by 2035 rely on this setup. Reducing the overall contribution to the plan reduces earnings and provides less funding for paying down the UAL.

This is a primary reason you cannot separate this issue into "legacy costs" and "going forward." The decisions made as part of "going forward" have a direct bearing on the ability to pay the UAL. Until the UAL is paid off, every alternative discussed must be weighed in terms of its impact on the ability to pay the UAL.

There are also some defined contribution costs that, at this point, have not been examined. During the Study Commission process, KPERS provided an analysis of administrative issues and costs that will arise with the implementation of a defined contribution plan or a defined contribution plan component. Since this plan has a defined contribution component, those issues must be considered.

The biggest issues surround employer reporting. The report KPERS provided to the Study Commission on December 7, 2011, indicates that implementation of a defined contribution plan would "require 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 separate contribution rate elements for the payroll." The report goes on explain that currently, KPERS performs full reconciliation of reports on an annual basis; implementation of a defined contribution plan would require this reconciliation to occur each payroll period. The KPERS report concludes, "This shift is likely to entail significant information system and other operations costs for each employer."

The report goes on to address changes a defined contribution plan would require to information systems. The report states:

> *A key cost component would be information technology costs, particularly during the start-up and implementation*

phase…implementation of a defined contribution plan would involve major changes to KPERS information systems…an increase in electronic reporting by employers would add a lot of incoming communications to our network, which may require additional servers to manage the load. Fail-over servers to protect against hardware failure of the primary devices may also be required. For employers that do not transit information electronically, the capabilities of KPERS' web portals may need to be enhanced to handle the load of additional logins to update pay information. Significant growth in the amount of data being stored could 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.

The report does not assign a set dollar cost to the information technology needs.

A plan is not viable if it cannot be implemented by the participating employers. To my knowledge, this committee has heard no testimony from participating employers or KPERS indicating if, when, or how the required changes associated with defined contribution plan reporting could be implemented or the costs associated with that implementation. The State and all of its political subdivisions have had budgets impacted by the economic downturn. It is not viable, or responsible, to just assume that the various KPERS participating employers will have the financial resources and time to implement such significant system changes. Additionally, KPERS itself will require additional funds to upgrade its information technology equipment. These administrative costs are on top of the additional dollars it will take to fund this plan.

It is also worth noting that currently KPERS administrative costs per member are $44. This cost is $46 below the peer average of $90, and is 4th lowest in the CEM Benchmarking study of eight-eight pension systems in which KPERS was considered. By contrast, a presentation from Nebraska showed defined contribution plan administrative costs of $92 per member, more than double the current KPERS cost. There can be no doubt that adding a defined contribution component will bring with it significant administrative cost increases, increases which the bill indicates will be passed on to employees.

THE PLAN WILL NOT PROVIDE AN ADEQUATE BENEFIT

You have heard numerous presentations, including the ones from Dimensional Advisors on Monday, that DC plans simply do not provide an sufficient benefit. You have seen that Nebraska and West Virginia have attempted defined contribution plans, only to later reject those plans because of poor performance. Despite that fact, this proposed plan places the biggest share of retirement savings into a defined contribution plan. It also reduces the amount

of money that goes into the one account that provides employees what they really need: a guaranteed benefit they can count on at retirement. If the State wants to spend more money on a retirement plan, the State should either make a larger employer contribution or pay more towards the UAL. Either of those actions would go much further to improving the sustainability of our pension system than adding a defined contribution component.

CONCLUSION

Both last year's legislature and the Study Commission spent a great deal of time studying various plan designs and alternatives. I saw this plan, and many other iterations, modeled during the Study Commission process. We looked at the cost of a plan very similar to this one versus the benefit provided, and there just isn't an upside to justify the additional costs. It doesn't improve benefits and it doesn't have a mechanism to off the UAL. It is simply change for the sake of change. By contrast, the cash balance plan currently set to take effect represents a compromise position. It more evenly balances risk between employer and employee, helps pay down the UAL, and provides a guaranteed benefit based on all contributions, both employee and employer.

You have heard some people promoting the DC plan based on employee choice. Employees already have the option to supplement their retirement earnings through a 457(b) deferred compensation plan. The system already provides choice for those who wish to save more money for retirement. There is no reason to add cost and complexity to the system.

The cash balance plan as it exists is a solid solution based on empirical data from other states. It is a bipartisan solution, reached after extensive study and discussion. I urge you to stay the course, honor the work that has already been done, and allow the cash balance plan to take effect. Thank you, and I will be happy to stand for any questions.

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