

## MEMORANDUM

To: House Committee on Pensions and Benefits  
From:  Alan D. Conroy, Executive Director  
Date: February 20, 2015  
Subject: House Bill 2288

House Bill 2288 would create a Deferred Retirement Option Plan (DROP) for all state KP&F members and local KP&F members whose employers opt in to the DROP.

### Background

A Deferred Retirement Option Plan (DROP) is a plan design feature where a member initiates the calculation of a retirement benefit, but opts to defer actual receipt of the benefit for a specified period. During this specified DROP period, the member continues working and the member's benefit is credited to a notional account and made available in a lump sum when the member ultimately leaves employment.

From an employer perspective, a DROP can be viewed as a personnel management tool. When a member enters the DROP and chooses a specific number of years to continue working, the employer can plan for that position to become vacant at a pre-determined date in the future. This allows employers to bridge the gap between senior employees leaving in retirement and others moving up into management positions. Depending on the overall design of the pension plan and the demographics of its members, the availability of a DROP may also provide an incentive for long-term employees to remain in the workforce for a longer period of time.

To employees, a DROP plan provides the ability to accrue an account balance while still working and receive a lump sum payment at ultimate retirement. A common time to enter a DROP is the point at which a member reaches a benefit cap. In those cases, the pension benefit is not likely to increase materially if the employee remains employed, unless the member experiences significant pay increases that increase the final average salary. In those instances, the availability of DROP plan may provide some benefit to continued employment for eligible members.

Two factors make the attractiveness of the DROP plan for KP&F harder to ascertain. First, KP&F members currently have the option of selecting a partial lump sum option payment at retirement. The partial lump sum option can range from 10% to 50% of the actuarial present value of the member's projected lifetime benefit. Like the DROP plan, this benefit payment option provides a lump sum of assets that can be received in cash or rolled over to another

retirement plan at retirement. Participants in the DROP plan would be prohibited from selecting a partial lump sum payment option.

Second, the existing KP&F plan design is likely to make it more difficult for KP&F members to determine whether participating in the DROP plan is to their financial advantage. For KP&F members, it takes 36 years of service to reach the plan's benefit cap (90% of final average salary). As a result, a significant number of members who have reached their normal retirement age (and therefore would be eligible for the DROP plan provided by HB 2288) would still be earning additional benefits for a number of years after becoming eligible. Therefore, in a number of instances, members will be weighing whether it is to their benefit to receive a higher benefit for a shorter period of time (if they do not participate in the DROP plan), compared to a lower benefit for a longer period of time. The following two examples illustrate the varying impact (in terms of present value) that participating in the DROP plan could have, depending on an individual member's circumstances. In both cases, the salary at DROP entry date is \$75,000

**Example 1: Higher Value if DROP Elected**

Age at Termination of Employment: age 55

Age at Participation in DROP: age 50

Years of Service at Termination: 30 years

Years of Service at DROP Date: 25 years

Salary increases age 50 to 55: 2% each year

Annual Benefit at DROP Date: \$45,962

Annual Benefit with Continued Accruals: \$60,895

Balance in DROP Account at age 55\*: \$244,018

Present value of benefit with Continued Accruals: \$672,623

Present value of benefit if DROP Elected for 5 Years (incl. DROP account balance): \$751,688

Ratio of present values under DROP vs. Continue to Work: 1.118

\*Assumes 3% average annual interest credit

**Example 2: Election of DROP Produces Lower Value**

Age at Termination of Employment: age 65

Age at Participation in DROP: age 60

Years of Service at Termination: 20 years

Years of Service at DROP Date: 15 years

Salary increases age 60 to 65: 4% each year

Annual Benefit at DROP Date: \$27,057

Annual Benefit with Continued Accruals: \$43,892

Balance in DROP Account at age 65\*: \$143,650

Present value of benefit with Continued Accruals: \$416,090

Present value of benefit if DROP Elected for 5 Years (incl. DROP account balance): \$400,147

Ratio of present values under DROP vs. Continue to Work: 0.962

\*Assumes 3% average annual interest credit

## Cost Considerations

The two primary cost considerations with HB 2288 are the actuarial cost of the DROP plan design and the administrative costs to execute the provisions of HB 2288.

Given the current provisions of HB 2288, it is nearly impossible for us to provide any type of reliable actuarial cost estimate for the DROP. Two factors, in particular, affect the impact of the DROP plan on KP&F and employer costs – the option for local employers to participate in the plan, and potential changes in retirement decisions of members eligible for the DROP plan. Therefore, the voluntary nature of the program for employers means that both the pool of eligible members and the actual KP&F members participating in the DROP is unknown.

Based on the language in the bill, employees of the state of Kansas are eligible for the DROP, but other employers must affiliate with the DROP in the same manner as provided by law for local employers to elect to participate in KP&F (K.S.A. 74-4954). The bill also requires each participating employer to pay the system an amount sufficient to satisfy the obligations under the DROP, as certified by the KPERS Board. The requirement that DROP employers pay the cost of the DROP plan dictates that this group be calculated separately for valuation purposes.

HB 2288 only specifies that one employer, the State of Kansas, will be a DROP employer upon passage of the bill. It is not possible to estimate with any certainty how many local employers will opt in to the DROP plan. Likewise, it is not possible to estimate how many members will elect to enter the DROP if their employer decides to affiliate with the DROP group.

Recognizing the limitations that exist at this time, KPERS' consulting actuary (Cavanaugh Macdonald) did provide a cost analysis under two different scenarios, although neither is likely to occur exactly. Instead the two scenarios may provide some insight into the cost impact of adding the DROP if: (1) all employer participating in KP&F elect to participate in DROP and (2) no employers elect to participate in the DROP, so that only state employees are covered by the DROP.

**Scenario 1.** The illustrations contained in the actuarial cost study suggest that if all KP&F employers adopted the DROP the actuarial required contribution, the impact may involve marginal savings or increased costs of less than 0.5%. If members electing into DROP ultimately work until a later age, the costs will be slightly lower. However, if a member leaves covered employment at the same ages as they currently do, but simply elect into DROP for three to five years before leaving, the cost will be slightly higher. This increase is due, at least in part, to a shift in which benefits begin earlier than under current actuarial assumptions.

**Scenario 2.** Under the second scenario where only the State adopts the DROP, the illustration shows an increase in the actuarial required contribution of 4 percent, from 20.42 percent to 24.41 percent, before considering the potential impact of the DROP plan. This increase is due to the specific demographics of the state group. When the DROP plan is added into the illustration, the additional costs due to the DROP plan are comparable to those in the first scenario.

As noted, these are illustrations and should not be considered reliable projections suitable for budgeting purposes. However, these two scenarios give an idea of how the actuarial required contribution could be affected by HB 2288.

**Administrative costs.** From an administrative standpoint, HB 2288 requires modifications to the information technology systems, member and employer services, and actuarial costs. The following table summarizes the estimated administrative costs to KPERS if HB 2288 is passed:

| <b>KPERS Estimated Administration Cost for HB 2288</b> |                   |                  |                  |
|--------------------------------------------------------|-------------------|------------------|------------------|
|                                                        | FY 2016           | FY 2017          | FY 2018          |
| Information Technology                                 | \$ 170,240        | \$ 0             | \$ 0             |
| Actuarial Costs                                        | 10,000            | 10,000           | 10,000           |
| Member and Employer Services*                          | 48,231            | 48,813           | 49,189           |
| <b>Total</b>                                           | <b>\$ 228,471</b> | <b>\$ 58,813</b> | <b>\$ 59,189</b> |

\* Costs are for 1.0 FTE position

I hope this information is helpful. I would be happy to respond further to any questions the Committee may have.