

MEMORANDUM

To: House Pensions and Benefits Committee
From: Alan D. Conroy, ^{ADC} Executive Director
Date: February 23, 2015
Subject: Actuarial Assumptions in HB 2288 Cost Study

At the February 20, meeting the Committee received an actuarial cost study on HB 2288, which would create a deferred retirement option program (DROP) for KP&F. The nature of the proposed DROP plan required KPERS' consulting actuary to make several assumptions in developing a cost analysis of the plan. The Committee requested additional information on the development of those assumptions.

DROP Account Interest Credit Rate

For the scenarios exploring the potential advantage or disadvantage to members selecting to enter the DROP, Cavanaugh Macdonald used a 3% interest crediting rate on the DROP account.

The selection of an interest crediting rate was based on the parameters set out in HB 2288 rather than analysis of potential future investment returns. HB 2288 stipulates that the Board of Trustees can provide a discretionary dividend of up to 7% in years when the investment return on trust fund meets or exceeds the 8% return assumption. However, the total interest credit cannot be more than 50% of total investment return. As an example, if the trust fund experienced a return of 10%, the Board could then provide an interest credit on the DROP accounts of no more 5%. Moreover, while the KPERS' portfolio has returned more than 8% over the last 25 years, it exhibits considerable volatility. Therefore, there would be a 0% interest credit to DROP accounts approximately half of the time.

With those parameters in place, the actuary opted to use an interest credit rate assumption of 3% to recognize the limited nature of the discretionary dividend, but not choosing an interest rate so low as to underestimate the costs to the System.

Cost Drivers of the DROP

While it is very difficult to determine with any certainty the ultimate costs of HB 2288, the Committee requested information on the primary cost drivers of the DROP.

From the employer perspective, requiring the State to offer the DROP plan, but making it optional for other employers appears to have the potential to cause greater shifts in employer contributions. When only a small group of members is included in a separate valuation, the demographic makeup and experience of that group can differ enough from



the larger group that the liabilities and resulting employer contributions vary significantly from the larger group. Thus, in the case of State KP&F members, their share of the KP&F liabilities for inactive and retired members is greater than for the KP&F membership as a whole, and therefore, a valuation based on their demographics alone is projected to increase the employer contribution rate by about 4%. Moreover, the contribution rate for a smaller group would experience considerably greater volatility over the years. Therefore, more employers electing to offer the DROP may reduce potential volatility.

The cost drivers of the DROP plan itself are more speculative. In general, the design of the proposed DROP plan limits some potential cost drivers, for example, by requiring employer and employee contributions to the System while members are in DROP. Which employees select the DROP plan may have an impact on the cost of the plan (their final average salary, years of service, etc.). However, the point at which they enter DROP is more likely to be a significant factor.

- If the DROP plan functions as intended and members work additional years, then members enter the DROP plan at the point they would otherwise have begun receiving benefits in the absence of the DROP plan. In that case, existing KP&F retirement patterns remain, and the DROP plan's impact may be closer to cost neutral.
- However, if members simply choose to enter DROP in the three to five years before the point at which they would otherwise have retired, they will receive benefits for a longer period of time, thus increasing the plan's liabilities and employer costs. Of course, member behavior cannot be reliably predicted in advance.

From an employee perspective, electing the DROP will be a calculated decision based on their assumptions for the future. Because members will be eligible to enter the DROP well before they reach the KP&F benefit cap (90% of final average salary at 36 years of service), the member will have to decide if they will benefit more from entering the DROP and accumulating a balance in a DROP account or simply continuing to work without entering DROP and increasing their multiplier (2.5%) and final average salary. The major considerations for employees are their potential salary growth during those years (higher final average salary), years of service (a larger proportion of total benefit for those with less service), and age (number of years receiving benefit after retiring).

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