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Shawn Sullivan, Director of the Budget

Sam Brownback, Governor

February 20, 2015

The Honorable Steven Johnson, Chairperson
House Committee on Pensions and Benefits
Statehouse, Room 286-N
Topeka, Kansas 66612

Dear Representative Johnson:

SUBJECT: Fiscal Note for HB 2288 by House Committee on Pensions and Benefits

In accordance with KSA 75-3715a, the following fiscal note concerning HB 2288 is respectfully submitted to your committee.

HB 2288 would create the Deferred Retirement Option Program Act (DROP) within the Kansas Police and Fireman's Retirement System (KP&F). A 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.

The DROP would be available to all State KP&F members and any local KP&F members whose employers have opted into the DROP plan. Participating members would continue working throughout the selected period. Both the employer and employee would continue to make contributions to KP&F. Participating employers affiliated with the DROP would pay the full actuarial required rate certified by the Board of Trustees, as calculated on the group of affiliated DROP employers. Members would be eligible to participate in the program upon reaching normal retirement age. Tier 1 members (before July 1, 1989) would be eligible at age 55 with 20 years of service. Tier 2 members (after July 1, 1989) would be eligible at age 50 with 25 years of service, age 55 with 20 years of service, and age 60 with 15 years of service. Members could elect to participate in the DROP for a minimum of three years and a maximum of five years. The election would be irrevocable. If a member decides to terminate participation in the DROP before the minimum of three years, the member will be eligible to receive only the amount of monthly benefits accrued, but no interest as provided by the Board of Trustees. If a member elects to continue working beyond the maximum of five years, the members' notional account balance will no longer earn interest as provided by the Board of Trustees.

DROP members would receive an accrual each month deposited into their notional account. The DROP accrual would be equal to the monthly retirement benefit calculated on the day the member elects to enter the DROP. The DROP accrual and retirement benefit would be based on the member's service and final average salary as of the end of the last payroll period

before the member enters the DROP plan, as well as the member's retirement option selection. At the time that participation in the DROP ends, the DROP account can only be paid in either a single lump sum payment or as a rollover of the full amount of the DROP.

An interest rate of up to a maximum of 7.0 percent would be established by the KPERS Board of Trustees and would be credited annually to each member's account. Interest credit would be provided only in a year when KPERS investment return has exceeded the 8.0 percent investment return assumption. The interest credited cannot exceed 50.0 percent of the actual rate of return.

A cost study was conducted by the KPERS actuary to assess the possible effects of HB 2288. The actuary notes that there are two factors that make reliable estimates difficult: the option for local employers to participate in the plan, and potential changes in retirement decisions of members eligible for the DROP plan. Regarding the effects of employer participation option, the bill 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 actuary indicates that this will be impossible to do without segregating the employers who participate in the DROP and performing a separate actuarial valuation to determine their appropriate employer contribution rate. Effectively, KP&F would be split into two groups, each with their own "uniform contribution rate." Also, the unfunded actuarial accrued liability would need to be allocated among the two groups, which would have an impact on the uniform contribution rate for each group. Amortization of any unfunded actuarial liability accruing over time due to the affiliation into the DROP would be paid in addition to the applicable uniform contribution rate for the DROP group.

Regarding the effects on retirement decisions, the KPERS actuary indicates that it is difficult to anticipate the impact of the DROP on the ultimate retirement patterns of eligible members. Actuarial assumptions regarding retirement rates are based on observed patterns of retirements among those eligible to retire. In general, the value of a member's retirement benefits is greater at the point the member first becomes eligible for unreduced retirement benefits (normal retirement) than at a later date when retirement has been delayed for a period of time after reaching normal retirement age. Therefore, plan design changes that provide incentives for members to begin receiving benefits earlier than under current actuarial assumptions tend to increase the actuarial liability and costs of a plan. Likewise, plan design changes that provide incentives for members to delay receipt of benefits beyond existing actuarial assumptions may tend to reduce the plan's actuarial liabilities and costs. As a result, the potential cost of the proposed DROP plan would depend in part on how the plan affects member retirement decisions. If members generally enter the DROP plan around the time they would have otherwise retired, there would likely be a small decrease in the actuarial liabilities. However, if members enter the DROP plan three to five years before they would otherwise have typically retired without DROP, they would receive benefits that are smaller, but for a longer period of time, with the potential for an increase in the actuarial liability.

The actuary indicates that it is very difficult to develop assumptions regarding member behavior with respect to participation in the DROP. In general, it is expected that members would make decisions that are in their own best financial interest and that the DROP would

result in higher costs. Given this limitation, two scenarios to illustrate potential costs were provided in the study.

In the first scenario, it was assumed that all KP&F employers elect to offer the DROP and 75.0 percent of eligible members elect into DROP for the lesser of five years or until age 62. Within this scenario are two cases: members extend their retirement age or members retire at the same ultimate retirement age. In the case where retirement age is extended, the employer contribution rate decreases from the current rate of 20.42 percent to 20.33 percent. This would create small amounts of state employer contribution savings of $20,430 in FY 2016 and $42,493 in FY 2017. In the case of the same ultimate retirement age, the employer contribution rate increases to 20.83 percent. This would create additional state employer contribution costs of $93,068 in FY 2016 and $193,581 in FY 2017.

The second scenario considered only state employees. Under HB 2288, the only group that would definitely be eligible for the DROP is state employees. Participation by other employers would be strictly voluntary. In order to assess the ongoing cost of the DROP solely to the employers who participate in that plan design, a separate actuarial valuation would be required for that group. Moving the state employees into a separate group for valuation purposes has a small impact on the valuation results for the other participating KP&F employers, but a significant impact on the costs for the state. When the state employees are valued as a separate group, the employer contribution rate increases to 24.41 percent before the potential impact of the DROP is assessed. The effects of the DROP in this scenario can be assessed in the same manner as the first scenario. In the case where retirement age is extended, the resulting rate would be 24.32 percent and could cost the state an additional $885,279 in FY 2016 and $1,841,380 in FY 2017. The rate for cases in which members retire at the same ultimate retirement age would be 24.85 percent. This would create additional costs of $1,005,586 in FY 2016 and $2,091,619 in FY 2017.

KPERS states that there would be administrative costs of $228,471 in FY 2016 and $58,813 in FY 2017 from the passage of HB 2288. The additional expenditures would include modifications to information technology systems, additional member and employer services, auditing costs, and actuarial costs. The total FY 2016 amount includes a one-time expenditure of $170,240 for information technology changes; $10,000 for the additional actuarial costs caused by the additional valuation required by HB 2288; and $48,231 for the salary and benefits of 1.00 FTE position to enroll members, track member accounts, and provide member and employer education. In FY 2017, the costs include $10,000 for the actuarial expenses and $48,813 for the new position. Any fiscal effect associated with HB 2288 is not reflected in *The FY 2016 Governor's Budget Report*.

Sincerely,

Shawn Sullivan,
Director of the Budget

cc: Faith Loretto, KPERS