MEMORANDUM

To: Senate Assessment and Taxation

From: Alan D. Conroy, Executive Director

Date: March 16, 2022

Subject: Senate Bill 553; Kansas Thrift Savings Plan

Senate Bill 553 creates a new defined contribution retirement plan for all KPERS members hired on and after July 1, 2024. The new plan is named the Kansas Thrift Savings Plan. Members of the KP&F and Judges retirement systems are not included in the Kansas Thrift Savings Plan.

Defined Benefit/Defined Contribution Comparison

A defined benefit plan, like KPERS, is commonly called a pension plan. Defined benefit plans are employer-sponsored retirement plans where employee benefits are calculated using a formula. The most common defined benefit formula uses years of service x final average salary x a statutory multiplier. In defined benefit plans, assets are pooled into a trust fund and all assets are available to pay the benefits of members of the group (i.e., no individual accounts). Portfolio management and investment risk for the plan are typically handled centrally by a Board of Trustees. Defined benefit plans promise a lifetime benefit to vested members. There are restrictions on when and by what method an employee can withdraw funds without penalties.

A defined contribution plan is a retirement plan that is typically a tax-deferred plan in which employees contribute a fixed percentage of their paychecks in an individual account. The employer also makes contributions into an individual member account. The employee is responsible for selecting how their funds will be invested among the investment options offered by the plan. Defined contribution plans have no guaranteed benefit. Employees bear all the risk for their retirement including investment risk, wage inflation, post retirement inflation, and longevity risk. Defined contribution plans place restrictions on withdrawals from these accounts such as minimum age for beginning disbursements.

Governmental Defined Contribution Plans

Government sponsored defined contribution plans are similar in structure to 401(k) plans in the private sector, but there are different Internal Revenue Service (IRS) requirements for governmental plans, so the Kansas Thrift Savings Plan would be established under sections 401(a) and 457 of the internal revenue code.

KPERS

Governmental defined contribution plans are not particularly rare. Several states, including Alaska, Michigan, Minnesota, Utah and Oklahoma, have defined contribution plans as a primary retirement plan. Several other states including Colorado, Florida, Indiana, Iowa, Montana, North Dakota, Ohio and South Carolina, offer at least a portion of new members an option to elect into a defined contribution plan as a primary retirement plan.

However, defined benefit plans, like KPERS, are still the most common state level governmental retirement plan in the United States.

Kansas Thrift Savings Plan Structure

SB 553 sets out the general parameters of the Kansas Thrift Savings Plan structure. Some parts of the Kansas Thrift Savings Plan are specifically laid out in the bill and are discussed below. However, certain plan provisions are not fully addressed in the bill. Most administrative decisions, including whether the plan is administered directly by KPERS or by a contracted third-party administrator, are delegated to the Board of Trustees.

Plan Coverage

SB 553 makes the Kansas Thrift Savings Plan the <u>mandatory plan for new members after July 1, 2024</u>. This closes the existing defined benefit plan, although with more than 300,000 active and retired members, the defined benefit plan will continue to exist for decades.

Member Accounts and Contributions

Each member who elects to participate in the thrift savings plan would have four accounts:

1. <u>Member mandatory contribution account</u>. Each member is required to contribute a minimum of 6%. Contributions can be pre-tax or post-tax (Roth). The member is immediately vested in the member mandatory contribution account and any interest earned on the account.
2. <u>Member deferred compensation account</u>. Members are auto-enrolled in a 457 plan and have an initial contribution of 1%. That contribution automatically increases 1% per year up to a maximum of 10%. The member can elect to change their contribution, but without action the member will automatically make additional contributions to this account. The member is immediately vested in the 457 account.
3. <u>Employer contribution account</u>. The employer contributes a base of 4% of pay, with increases as member contributes at a higher rate. Employer contributions are 4.5% if the member contributes 1% to the 457 account and 5% if the member contributes 2% or more to the 457 account. The member vests in the employer contribution account after five years of participating service in the Thrift Plan.
4. <u>Rollover account</u>. SB 553 requires the plan to accept rollovers (e.g., assets from another retirement plan) from eligible retirement plans and the assets from

rollovers are deposited into the member's rollover account. The member is immediately vested in the rollover account.

The bill specifies that there be both a Roth (after tax) contribution option and that the employer contributions will be "picked up" by the employer (deducted through payroll on a pre-tax basis). It does not appear that Roth contributions can be "picked up" by the employer so additional clarifying language on employer contributions may be necessary.

Investments

Each member is responsible for choosing the investment of the total balance of their accounts. SB 553 requires six investment options for members to select:

1. Government securities fund
2. Fixed income index fund
3. Common stock index fund
4. Small cap index fund
5. International stock index fund
6. Target date fund (a fund that adjusts over time based on retirement date)

The Board of Trustees is responsible for selecting the specific investments that fit in these six broad categories. The Board is given the authority to offer additional investment options, but these six investment options are required.

The Board of Trustees is also delegated the responsibility of selecting a default investment for members who fail to make an investment selection.

Distributions

Members can file application for distribution of vested account balances at any time after they terminate employment.

Distributions can be made by direct rollover, "regular" rollover, lump-sum distribution or some combination of those options. In addition, the Board of Trustees is given the authority to offer additional distributions options including offering an annuity option "from an insurer." At this time, it is assumed that the insurer would be a third-party company that offers annuity products.

If a member who leaves employment is not vested in the employer contribution account, the balance of the account is forfeited and used to pay the administrative expenses of the Kansas Thrift Savings Plan.

One-Time Election for Current Members

<u>SB 553 allows for one-time, irrevocable election of all existing KPERS members to switch to the Kansas Thrift Savings Plan, if allowed by the Internal Revenue Service (IRS)</u>. Members who elect to switch would have a calculation of the present value of their

future benefits and an equivalent amount would be transferred from the defined benefit plan to their rollover account in the thrift plan.

A calculation of the present value of future benefits requires the use of certain actuarial assumptions to determine the amount of the present value. The bill does not specify the assumptions to be used and does not directly delegate the Board of Trustees with the authority to set these assumptions. Furthermore, the calculation of a KPERS 3 member's accrued benefit is less direct than KPERS 1 and 2. It is likely the calculation will not be equal to the KPERS 3 member's combined employee and employer account balances.

The election section of SB 553 is severable from the rest of the bill if the IRS does not approve of the election. Based on the structure of this plan and discussions with our outside tax counsel, <u>we believe the IRS would allow this election for current members</u> because the employee contribution rate is the same in either plan and therefore does not create a "cash or deferred arrangement," which is not allowed under the Internal Revenue Code.

When an active KPERS member elects into the Thrift Savings Plan, an amount equal to the actuarial present value of future benefits is transferred from the KPERS Trust Fund to the member's rollover account in the Thrift Savings Plan. This formula is not clear on how KPERS 3 cash balance benefits will be calculated and additional clarifying language may be necessary to carry out the intent of the policy.

There both cashflow and actuarial funding considerations with this calculation. First is the need to cashflow a potentially large transfer out of the KPERS Trust Fund. Depending on the number of members who elect into the Thrift Savings Plan, the total amount of funds transferred out of the Trust Fund could be substantial and require changes to the investment portfolio to ensure enough funding is available to complete all of the transfers. The current investment mix may not have the liquidity necessary depending on the total amount of the transfers.

On the actuarial funding side, the total actuarial liabilities and assets will decrease as members elect into the new Thrift Savings Plan. However, not every member has the same liability, the mix of members who ultimately elect into the Thrift Savings Plan will impact the assets and liabilities that remain in the KPERS Trust Fund. Additional analysis can be completed to model the potential impact to the existing KPERS plan.

Defined Benefit plan contributions
SB 553 includes the payroll of the members that enroll in the Kansas Thrift Savings Plan is included in the calculation of employer contributions to the defined benefit plan. The funding of the defined benefit plan is based on total payroll. With the defined benefit plan being closed by the creation of the Kansas Thrift Savings Plan, the payroll in the defined benefit plan is expected to decrease in the future. A decreasing payroll creates a situation where the employer contribution rate can increase rapidly. Including the payroll of the

Kansas Thrift Savings Plan ensures that the employer contributions to the defined benefit plan can remain more stable.

When the unfunded actuarial liability of the defined benefit plan is funded, this policy of funding the defined benefit plan with the combined payroll of the defined benefit plan and Thrift Savings Plan may no longer make sense and could be revisited.

Administrative Considerations
Offering a defined contribution plan as a primary, employer-sponsored retirement plan is a foundational shift in Kansas retirement policy. KPERS has existed as a defined benefit plan since the 1960s and all administrative structures in place today are designed to administer a defined benefit plan.

SB 553 is not specific about who will be responsible for administering the Kansas Thrift Savings Plan; the bill allows either KPERS or a third-party administrator to handle the administration.

At this point, the assumption is that the Kansas Thrift Savings Plan would be administered through a contract with a third-party administrator, similar to the existing KPERS 457 plan, which is administered by Empower Retirement.

If a third-party administrator oversees the Kansas Thrift Savings Plan, employers would be required to submit their KPERS payroll and contribution information to KPERS and their Kansas Thrift Savings Plan payroll and contribution information to the third-party administrator. Any questions or issues that a thrift plan member has would be handled by the third-party administrator as well.

KPERS would be responsible for education efforts and administration for all members up until the point of making the election. After the election is made, KPERS administration would only apply to members staying in the defined benefit plan.

Startup Costs
One of the primary issues with the creation of a new defined contribution plan is how the startup costs are funded. All of the funds that KPERS oversees are trust funds, primarily the defined benefit plan trust fund. Trust fund assets can only be used for the benefit of the members of the trust group.

Using trust fund assets to start a new defined contribution plan is not allowed under trust fund law. The most obvious source of startup funding is a State General Fund appropriation. The startup costs could be structured to be recovered from the Kansas Thrift Savings Plan over time, but some funding source other than trust fund assets would have to be provided.

Administrative Costs
Creation of a new retirement plan will require extensive staffing and technical work to complete. Among KPERS' expected administrative start-up and on-going costs are:

- Actuarial services
- Defined contribution plan, investment and audit consultant services
- Legal services (both in-house and contractual)
- Communication/education costs
- Costs associated with a request for proposal for third-party recordkeeping, trust and investment services
- Ongoing contract monitoring, audits and reporting
- One-time costs for changes to KPERS' information technology system.

Our initial estimate is 15 staff members during the initial work and transition, with 7 of those positions being permanent staff after the transition. Assuming that a third-party administrator will be responsible for the tracking of member data, most of the technical work will be ensuring that KPERS can interface with the third-party administrator. When a similar defined contribution plan was introduced in 2019, the estimate information technology costs were $200,000. We are working on an updated estimate for the current bill.

Conclusion
Creating a new defined contribution plan for public employees in Kansas is a significant undertaking that will require careful planning and implementation. KPERS is not currently equipped to administer a defined contribution plan but can implement a defined contribution plan given proper time, funding and direction.

SB 553 provides a general framework for creating the Kansas Thrift Saving Plan. KPERS is continuing to review the bill language internally and with our outside tax counsel. KPERS believes some changes and additional language may be necessary to create the Thrift Savings Plan that complies with the Internal Revenue Service. Staff will work with the Committee on any necessary changes to the bill language at the appropriate time.

I would be pleased to respond to any questions the Committee may have.