Landon State Office Building
900 S.W. Jackson, Room 504
Topeka, KS 66612

Steven J. Anderson, CPA, MBA, Director

AD ASTRA PER ASPERA
Kansas
Division of the Budget

phone: 785-296-2436
fax: 785-296-0231
steve.anderson@budget.ks.gov

Sam Brownback, Governor

March 7, 2011

The Honorable Mitch Holmes, Chairperson
House Committee on Pensions and Benefits
Statehouse, Room 166-W
Topeka, Kansas 66612

Dear Representative Mitch Holmes:

SUBJECT: Fiscal Note for HB 2311 by House Committee on Pensions and Benefits

In accordance with KSA 75-3715a, the following fiscal note concerning HB 2311 is respectfully submitted to your committee.

HB 2311 would create a new mandatory defined contribution (DC) plan for all future members of the Kansas Public Employees Retirement System (KPERS), effective July 1, 2013. The KPERS Board of Trustees would be required to establish a separate DC plan within KPERS. The DC plan would be a qualified governmental plan as provided by Sections 401(a) and 414(d) of the Internal Revenue Code and related regulations. As such, all assets of the plan would be held in trust for the exclusive benefit of its members.

The new DC plan would become the primary retirement plan, which would be known as "Tier 3," and would include the following KPERS State, School, and Local Group employees: employees who are first employed in an eligible position on or after July 1, 2013, and inactive, non-vested KPERS members who return to work in an eligible position on or after July 1, 2013.

In addition, any member of Tier 1 or Tier 2 may make a one-time, irrevocable election to transfer to the Tier 3 DC plan within a 90-day window established by the Board. Those who do not make an election to transfer are considered to have made an irrevocable election to remain in Tier 1 or 2. The member's account balance as of the date of transfer would be credited to the member's DC plan account. The Tier 1 and 2 transfer option would not be implemented unless it is first approved by the Internal Revenue Service.

HB 2311 would identify treatment of service purchases and domestic relations orders for Tier 1 or Tier 2 members who wish to transfer to the new Tier 3 and would set out the election options for employees moving between positions covered by KPERS and the Board of Regents optional retirement plan established by KSA 74-4911. HB 2311 specifically states that it would not apply to members of the Kansas Police and Firefighters Retirement System or the Retirement System for Judges.

Employee Contributions

HB 2311 would require active members to contribute 6.0 percent of compensation, deposited in their mandatory contribution account. These contributions and the income earned on them would be vested immediately. The contributions would be made prior to tax calculations for federal income tax purposes. Members would not be permitted to make additional, voluntary contributions to their DC account. Tier 3 members could continue using any alternative supplemental retirement plans provided by their employer, such as the Kansas Public Employees Deferred Compensation Plan, the State's 457 plan. However, the DC Plan would accept rollover of contributions and income from another eligible retirement plan, within the limits of applicable federal law. Rollover contributions would be deposited in a separate rollover account, and the contributions and income earned would be vested immediately.

Employer Contributions

Participating employers would be responsible for making an "Employer DC Account Contribution," which would be defined as an amount equal to 3.0 percent of the active members' compensation. This contribution would be credited to the employer contribution account of each active member and would be vested only when the member has three years of participating service in the DC plan. In addition, there would be a "plan funding rate," which would be defined as a percent of active members' compensation determined by the Board. The plan funding rate would be paid to the KPERS defined benefit (DB) plan (Tiers 1 and 2) and would be set at a rate as necessary to fund the DB plan's unfunded liabilities on an actuarial basis and the change in the normal cost contribution rate that would result from establishing the new DC plan for future members and closing the existing DB plan. Also, there would be a "Death and Long-Term Disability Plan Rate," which would be a percent of active members' compensation determined by the Board to fund coverage of Tier 3 members under the insured death benefit and insured disability benefit provided by KSA 74-4927. Finally, an "Administrative Expense Rate," would be funded as a percent of active members' compensation determined by the Board to pay for costs incurred by the Board in administering the Plan.

Investments

The Board would be responsible for selecting and reviewing the investment alternatives offered through the DC plan. The investment alternatives may be those offered under the state's 457 plan, and the Board may change the alternatives offered after notifying affected members of the changes. Individual members are to direct the investment of their employee contribution account, their employer contribution account, if vested, and any rollover account. The Board is required to designate a default investment option for the employer contribution account of non-vested members and for the employee contribution account and rollover account of any member who does not select one or more investment alternatives. The default investment alternative may be a balanced fund.

Distributions

HB 2311 prohibits distribution or refund of any portion of a member's vested account balance before termination of service. Upon termination, the member can choose to terminate membership and receive a distribution of the member's vested account balance or to leave the vested account balance in the DC plan until a later date, subject to minimum distribution requirements under federal and state law. Distributions are to be made through one or more authorized payout options – a direct or regular rollover to an eligible retirement plan, a lump-sum distribution, or any other distribution option provided by the Plan Document adopted by the Board.

Death and Disability Benefits

HB 2311 provides coverage for active Tier 3 members by the same death and long-term disability benefits as Tier 1 and Tier 2 KPERS members. In addition, if a Tier 3 member receiving the insured disability benefit would become permanently and totally disabled, the member's employer would contribute 3.0 percent for the employer contribution and the 6.0 percent for the employee contribution until the member is no longer entitled to an insured disability benefit, up to a maximum of five years. The contributions would be based on the member's compensation at the time the member became disabled. Beneficiaries would be designated as provided in existing regulations for the DB plan and receive the member's vested account balance after the member's death.

Administration

HB 2311 would authorize the KPERS Board to contract for plan administration, consulting, investment, educational, recordkeeping or other services for the plan. The contracts would be awarded using a competitive proposal process, except that the Board may negotiate a contract with the current third party administrator for the state's 457 plan for a period not to exceed five years.

A separate account for paying administrative expenses for the plan may be established within the DC plan. Administrative expenses could be funded through a combination of assessments of fees on DC plan member accounts, negotiated vendor reimbursements, the administrative expense rate paid by employers on active member compensation, and forfeited employer contributions from non-vested members and earnings on those contributions. HB 2311 would authorize the expenditure of forfeited employer contributions for the Plan's start up expenses. The Board would be authorized to establish reasonable and necessary policies to administer the plan without the adoption of regulations.

HB 2311 establishes a member contribution rate of 6.0 percent, which is credited to the member's mandatory contribution account. Current rates for Tier 1 and Tier 2 members are 4.0 percent and 6.0 percent respectively. Retirement benefits for members of the new Tier 3 would be dependent on the assets accumulated in the members' accounts prior to leaving employment, as well as their investment returns and rate and timing of distributions following termination.

The fiscal effect of HB 2311 on participating employers would consist of several elements, including employer contributions to the DC accounts of Tier 3 members, the plan funding rate, and the death and disability benefits rate. In addition, the Board would have authority to establish an administrative expense rate as a source of funding for start-up or ongoing administrative expenses.

Employer contributions to Tier 3 members are referred to as an "employer DC account contribution" in HB 2311 and are set at 3.0 percent of members' compensation. The "plan funding rate" provides a means to take into account the effect of HB 2311 on the existing DB plan. In order to estimate the fiscal effect of establishing these two funding elements for HB 2311, several components of the funding for the existing DB plan are be considered. The actuarially required contribution (ARC) rate calculated each year for the KPERS DB plan consists of the "normal cost" rate and the unfunded actuarial liability payment. DB normal cost is the employer portion of the cost of projected benefits allocated to that year. Employee contributions are applied first to the normal cost, and the remainder is paid by the employer. DB unfunded actuarial liability (UAL) Amortization Payment is the annual payment to fund the KPERS' UAL. The UAL is the difference between the actuarial value of assets and the actuarial value of the liabilities for benefits. Therefore, the UAL must be paid whether or not the existing DB plan is closed to new members due to the establishment of a DC plan.

As of the December 31, 2009 actuarial valuation, 23 years remained in KPERS' UAL amortization schedule. However, because of the 0.6 percent annual cap on employer contribution rate increases in current law, the capped "statutory rate" is significantly lower than the ARC rate. This gap between the ARC rate and statutory rate is a central factor in the development of a substantial KPERS' long-term funding shortfall. The shortfall is large enough that the December 31, 2009 valuation indicated the KPERS' School Group is out of actuarial balance and that the UAL would not be fully amortized by the end of the amortization period in 2033. In order to pay off the current UAL by the end of its existing amortization period, additional contributions would be required, whether or not the current DB plan is closed to new members and replaced with a mandatory DC plan.

KPERS estimates that enactment of HB 2311 would not significantly increase total employer costs for State/School Group retirement benefits when compared to the current retirement system, also referred to as the "baseline." By design, the UAL would be paid at the same rate as the baseline. As a result, the primary differential between the baseline and HB 2311 is the employer's normal cost rate for the open DB plan, compared to the 3.0 percent employer DC account rate. Because they are similar, the composite or blended rate for all three Tiers of the State/School Group under HB 2311 is projected to be 21.65 percent by FY 2033, compared to the statutory rate under the baseline of 21.37 percent at the same point. Total projected State/School Group costs from FY 2011 through FY 2033 are comparable ($23.05 billion under the baseline and $23.23 billion with HB 2311, for a difference of $183.15 million or 0.8%), as are the maximum UAL ($9.32 billion with the baseline and $9.26 billion with HB 2311) and funded ratios (funded ratios of 60.0 percent and 80.0 percent are reached one year later under HB 2311).

HB 2311 provides for Tier 3 members of the DC plan to participate in the KPERS death and disability benefits plan. The 1.0 percent employer contribution rate is assumed to apply to KPERS member tiers. As a result, HB 2311 would not result in higher employer contributions for this benefit.

The new Tier 3 administrative expenses could be funded through a combination of assessments of fees on DC plan member accounts, negotiated vendor reimbursements, the administrative expense rate paid by employers on active member compensation, and forfeited employer contributions from nonvested members and earnings on those contributions. HB 2311 would authorize expenditure of forfeited employer contributions for the Plan's start up expenses. No estimates are available of the level at which the administrative expense rate would be set.

KPERS notes that it is not possible to fully identify and estimate the administrative and operational costs that would be associated with implementation of HB 2311 and with ongoing operations. One key cost component would be information technology costs. Although most responsibilities for recordkeeping, investment management, and communication/education services would be handled by a third-party administrator, implementation of HB 2311 would involve major changes to KPERS' information systems. In particular, new processes would need to be established to calculate, remit, and reconcile the four different contribution elements in HB 2311, and to coordinate them with and through the third-party record keeper. A very preliminary estimate of costs associated with modifications to KPERS' information systems is $277,500. If the portion of HB 2311 permitting Tier 1 and 2 members to opt into the Tier 3 DC plan is approved by the IRS and implemented, then additional changes to the information system would be required. The approximate cost for these information system changes is $75,600.

Specific cost projections for the Local Group are not available at this time. However, the same methodology for funding the State-School Tiers 1 and 2 would be applied to the Local Group, and it is expected that the effect of the employer DC account contributions, plan funding, death and disability, and administrative expense rates would be comparable in relative terms. Local government units may also have expenses associated with changes to payroll and accounting systems that may be necessary to remit and reconcile the separate contribution rate elements.

Sincerely,

Steven J. Anderson, CPA, MBA
Director of the Budget

cc: Faith Loretto, KPERS