

## MINUTES

### KANSAS PUBLIC EMPLOYEES RETIRMENT SYSTEM STUDY COMMISSION

November 7-8, 2011  
Room 346-S—Statehouse

#### **Members Present**

Senator Jeff King, Co-chairperson  
Representative Mitch Holmes, Co-chairperson  
Senator Laura Kelly  
Representative Steven Johnson  
Representative Ed Trimmer  
William Buchanan  
Edward Condon  
Fredrick Proccia  
Rebecca Proctor  
Michael Ryan  
Paul Seyferth  
Richard Stumpf  
Brian Winter (via telephone 11/08)

#### ***Ex Officio* Members Present**

Elizabeth Miller, Acting Executive Director, Kansas Public Employees Retirement System  
Alan Conroy, Director, Kansas Legislative Research Department  
Steve Anderson, Director of the Budget, Department of Administration

#### **Staff Present**

Julian Efird, Kansas Legislative Research Department  
Michael Steiner, Kansas Legislative Research Department  
J.G. Scott, Kansas Legislative Research Department  
David Wiese, Office of the Revisor of Statutes  
Daniel Yoza, Office of the Revisor of Statutes  
Connie Burns, Committee Assistant

#### **Conferees**

Roderick Crane, Teachers Insurance and Annuity Association – College Retirement  
Equities Fund  
Bernie Heffernon, ING Group  
Doug Wolff, Security Benefit Corporation  
Patrice Beckham, Cavanaugh Macdonald Consulting, LLC  
Brent Banister, Cavanaugh Macdonald Consulting, LLC  
Rebecca Floyd, Kansas Development Finance Authority  
Jim MacMurray, Kansas Development Finance Authority  
Frank Hoadley, Wisconsin Capital Finance  
Stuart Sedlacek, Investment Consultant

**Monday, November 7  
Morning Session**

The meeting was opened by Co-chairperson Holmes.

**Perspectives from Potential Service Providers for Defined Contribution Plans**

*TIAA-CREF*

Roderick Crane, Teachers Insurance and Annuity Association–College Retirement Equities Fund, (TIAA-CREF) provided a presentation on retirement system designs (Attachment 1). TIAA-CREF offers a range of government plans, investments, and plan sponsor services including communication, education, and advice. TIAA-CREF was established in 1918 by Andrew Carnegie with one central mission: to aid and strengthen academic, medical, cultural, and research institutions, and state and local governments by seeking to provide financial security for their employees. The mission remains the same today. TIAA-CREF has 7,000 employees and 60 offices nationwide.

The cost of public pension funding is increasing and several factors are contributing to the increase of public pension funding expenses:

- With returns lower than expected, market losses are driving up costs;
- Delayed funding has not been made up by market returns;
- Unfunded benefit increases have not been offset by budget increases; and
- Pension benefit abuses have a negative impact (*i.e.*, double-dipping).

The three core elements integral to government play an important role in helping to ensure retirement sufficiency for government participants:

- Core Pension Plan – Typically offered as a defined benefit plan and intended to help replace income at retirement;
- Social Security – May or may not be available to government employees, depending on local government participation; and
- Supplemental Plans – Typically a 457(b) plan designed to help government employees build personal savings.

TIAA-CREF provides three types of retirement plans addressing the needs of government programs:

- Defined contribution plans for a core pension – designed as either a hybrid Defined Benefit (DB)/Defined Contribution (DC) plan or a stand-alone Core DC plan;

- Supplemental plans (457, 401(k), 401(a)); and
- Retiree health care programs.

Hybrid DB/DC and Core DC plans offer two options for managing pension funding risks:

- Hybrid DB/DC plan - features a reduced DB benefit with a new risk-managed DC component, so the two plans exist side-by-side and reduce the sole reliance on a traditional DB plan; and
- Core DC plan – eliminates sole reliance on a traditional DB plan.

Unlike traditional 401(k)-style plans which focus on asset accumulation, both plan models focus on seeking to provide retirement security. The DB/DC and Core DC plans can be open to new and existing employees, depending on plan structure and state regulations. Both plan structures help provide government plan sponsors with more predictable costs and outcomes.

TIAA-CREF believes effective retirement programs should include choices suitable for all employees, which include the following elements:

- Majority of employees are advice-dependent or want a simple solution;
- Some want customization, but seek affirmation;
- Others will build their own portfolio, benefits, and investment policy should address process, prudence, and documentation;
- Effective process should facilitate and not sacrifice participant outcomes; and
- A diversified, low-cost menu often is the best strategy for long-term retirement investing.

TIAA-CREF's record keeping platform provides an open investment architecture and broad menu discretion with no proprietary fund requirements, investment menu neutral pricing, access to a variety of risk-managed retirement income products, including annuities and stable value, and availability of a self-directed brokerage window.

TIAA-CREF has a consistent, retirement-focused investment approach with skilled money managers focusing on strategies designed to help provide financial security in retirement. They believe financial literacy is the primary driver of financial security in retirement. Their messages, delivered through a variety of mediums, are educational and objective, and include the following:

- Investment education;
- Asset allocation and diversification principles;
- Planning and investment strategies;
- Monitoring and re-balancing concepts;

- Income needs and distribution options; and
- Integration of life's other goals.

Mr. Crane addressed questions and comments from the Commission.

### *ING Group*

Bernie Heffernon, Executive Vice President of Public Markets; Kenje Mallot, Vice President of Government Field Operations; John O'Brien, Managing Director; and Cindy Delfelder, Regional Director, ING Group, provided information on the public pension plans provided by ING Group ([Attachment 2](#)). ING Group has 35,000 participants and is the record-keeper for the State of Kansas 457(b) plan, and the Kansas Board of Regents 403(b) plan. Included in the presentations were tools that ING Group provides to help employees, which includes a checklist guiding them through a review of options leading to a possible solution for particular circumstances. Additionally, ING provided a white paper which puts this topic in perspective and provides insights on many of the components of the employee checklist. ING included a chart reflecting the plan designs being used in four states and the key features and details of Oregon and Michigan's retirement plans. ING Group addressed questions and comments from the Commission.

### *Security Benefit Corporation*

Doug Wolff, President, Security Benefit, testified on the necessity of advice, choice, and local control for the success of defined contribution plans. Mr. Wolff also spoke to the best practices in public sector defined contribution plan design ([Attachment 3](#)). Mr. Wolff stated Security Benefit supports a fully-funded KPERS defined benefit plan. Security Benefit is one of the five largest defined contribution providers in the United States specializing in public education retirement plans. Security Benefit specializes in working with K-12 public schools, and has a significant defined contribution practice that serves other governmental sectors, such as firefighters, city and county employees, and rural water district workers.

Security Benefit has learned a few things about retirement readiness planning:

- A multifaceted savings approach is absolutely necessary for individuals to close the retirement funding gap;
- Public employees need, and deserve, advice and guidance;
- KPERS serves a decentralized populace that deserves and requires equity of service; and
- Participant choice and control over sources of investment options and financial advice make a demonstrably significant difference in retirement savings rates.

The three-legged stool philosophy that KPERS is built upon, provides retirement plan benefits to public sector workers through a defined benefit plan. Social Security and personal savings make up the other two legs. There are four key factors contributing to improved

personal savings rates and, thereby, optimizing outcomes for defined contribution plan participants:

- Participant access to local, personal investment advisers without regard to location, assets, or ability to invest;
- Appropriate participant choice of advisers, investment providers, and investment options;
- Participant control of retirement plan assets, including the ability of the participant to aggregate all retirement assets with the adviser and investment provider of choice or diversify as desired; and
- Clear, uniform, and precise disclosure of fees and expenses for services rendered.

These key factors have proven to encourage positive retirement savings behaviors and any modification of the KPERS retirement plan design must support these factors.

Best practices in governmental retirement plan design and experiences in other public retirement systems demonstrate the optimal public defined contribution plan must:

- Integrate local professional advice for all worksites, irrespective of location or investable assets, in order to maximize personal retirement savings behaviors, which includes a 403(b);
- Use a flexible plan design that includes multiple IRS Code sections (403(b), 457, 401(a)) administered by an independent third-party administrator to maximize flexibility and savings options for participants;
- Allow participant choice and control of investment options with the ability to consolidate all plan assets with a single provider for increased savings rates;
- Allow each public education employer to add investment providers for all plan types;
- Require all providers to meet established administrative requirements; and
- Utilize disclosure of fees, services, and payments as the best practice for the plan sponsor and investment providers, rather than market restrictions.

Mr. Wolff addressed questions and comments from the Commission.

#### *Follow-Up and Requested Items from Actuary*

Patrice Beckham, Cavanaugh Macdonald Consulting, LLC, provided requested information on estimated employer contributions for FY 2012 to FY 2034 ([Attachment 4](#)). The baseline is current law with a 0.6 percent statutory cap. The Commission requested the same

information with the provisions of Senate Sub. for HB 2194, lifting the cap in FY 2013 and the full actuarially required contribution rate.

Ms. Beckham provided information on the value of KPERS liabilities if benefits were frozen ([Attachment 5](#)). Generally, this type of liability measurement is referred to as the Present Value of Accrued Benefits (PVAB). The table summarizes the current calculation using a 6.0 percent rate of return (new request), as well as the liability previously provided, which was based on an 8.0 percent rate of return. Ms. Beckham addressed questions from the Commission.

Co-chairperson Holmes recessed the meeting until 1:20 pm.

## **Afternoon Session**

### **Review of Pension Obligation Bonds**

Co-chairperson Holmes introduced Rebecca Floyd, Executive Vice President and General Counsel, and Jim MacMurray, Finance Vice President, Kansas Development Finance Authority (KDFA), to speak about pension obligation bonds ([Attachment 6](#)). The KDFA was established by statute in 1986 as a conduit finance authority to efficiently access the capital markets on behalf of the state and other public and private borrowers. KDFA works with its finance teams to structure efficient bond issues in compliance with state and federal regulatory requirements, and provides significant post-issuance administration and debt management resources to maintain ongoing compliance with state and federal regulatory requirements.

Bonds issued as tax-exempt obligations, except for certain limited exceptions that are related primarily to bond proceeds' spend-down, must submit any investment earnings in excess of the bond yield to the federal government in the form of arbitrage rebate payments. The *Kansas Constitution* places significant constraints on the state from issuing general obligation bonds. However, pension obligation bonds are allowed, as they are typically structured as fairly simple fixed rate issues, designed to lock in an interest cost with the ultimate goal of attaining a rate of investment return, which is materially higher than the bond rate. The debt service for the bonds is paid from the State General Fund, subject to appropriation by the Kansas Legislature. Pension obligation bonds must be issued as taxable bonds.

The state's current Issuer Credit Rating (ICR) of S&P 'AA+' and Moody's 'Aa1' (negative outlook) is likely to be downgraded, but not certain. Pension bonds are used as an asset-liability management tool and the state's liability profile does not change significantly from the rating agency's perspective, but budget flexibility for expenses does.

In theory, over the very long term, KPERS would expect to invest the bond proceeds and earn more in investment returns than the state would pay in debt service on the bonds. A \$5.0 billion issue is a large transaction for the municipal market which recently has had weekly volume of about \$10.0 billion. Breaking the transaction into smaller pieces would help reduce timing risk for both the debt issuance and the associated asset purchases, and also increase the pricing efficiency of the debt issuance.

The Commission discussed what types of bonds the state could issue and KDFA was asked to provide the Commission with answers after further study.

Frank Hoadley, Wisconsin Capital Finance Director, provided another state's perspective on bonding. Mr. Hoadley stated the key is plan design and the unfunded liability being funded. The KDFA stated the problems and the solutions, and have experience with this type of problem. (This presentation was provided via telephone.)

Stuart Sedlacek, Investment Consultant, provided a PowerPoint presentation on cost and benefits comparisons of plans and bonding strategies ([Attachment 7](#)). Two factors will reduce KPERS plan's Expected Compounded Annual Investment Returns (ECAIR):

- Volatility of returns – expected volatility of returns reduces the ECAIR; and
- Low Bond Market Yields – expected returns will be reduced due to current Bond Market Yields which are 2.0 percent to 2.5 percent below long-term historical averages.

There are several attributes of Defined Contribution Plans. An individually-owned Defined Contribution Plan has at least two significant advantages over a Defined Benefit plan. First, from an investment perspective, each participant has his or her own portfolio; and the employee can create a personalized investment strategy using their own time horizon, which raises their expected returns. Second, from a portability perspective, the employee has an asset which they do not forfeit in the case of change of employment and death:

- The employee can take the fund balance with them if they change employers;
- The heirs of the employee inherit the fund balance when the individual dies;
- Conclusions after analysis of current KPERS plan;
- The plan is likely to have underfunded retirement liabilities for a large cohort of employees, especially given current bond market yields and prospective returns;
- The Defined Contribution plan design offers the high likelihood of delivering higher accumulated fund balances by utilizing more aggressive, yet prudent, personalized investment strategies; and
- The Defined Contribution plan design could enable the state to be more competitive with other employers by offering retirement fund portability and inheritability.

A possible way forward for KPERS would be to “tie off” the current defined benefit plan and not create any new retirement liabilities under current plans, discontinue salary-based contribution to the fund, determine current unfunded liabilities (current assets less present value (PV) of current retirement benefits), and issue debt at current low interest rates to fully fund the plan. It would create the blended DB/DC plan:

- For the DB component – Modify the benefit earned by years of employment to produce adequate funding at target likelihood of success, the benefit rate will decline for each year of employment as employee's age increases (years to

retirement decreases), apply DB component to a percentage of salary or to the first \$X,000 of salary; and

- For the DC Component – Create a DC plan component and make the DC plan option available for 100 percent of salary at the time the plan is revised. The plan also would be available for all new hires, provide education and targeted-mix funds for employees to address the tendency to “sub-optimize” asset allocation of investment, and arrange for annuitization/immediate-annuity option for DC plan balance at retirement. The annuity would create a fixed income stream for retiring employees (to be provided by state or by third-party provider); or
- Create 100.0 percent Defined Contribution plan - Make DC plan option available for 100.0 percent of salary at time of plan revision and for all new hires. The plan would create an annuitization/immediate-annuity option for retiring employees (to be provided by state or by third-party provider).

Mr. Sedlacek addressed questions and comments from the Commission.

The meeting was adjourned until Tuesday, November 8, at 9:00 a.m.

### **Tuesday, November 8 Morning Session**

The meeting was opened by Co-chairperson Holmes. The Co-chairperson stated the agenda would include requests for information from previous meetings and models from the KPERS Actuary. The meeting was webcast live on the Internet.

#### **Continuation of Report from KPERS Actuary on Models and Other Requested Information**

Patrice Beckham and Brent Banister, Cavanaugh Macdonald Consulting, LLC, presented follow up items from previous meetings. The information requested was the provision of Senate Sub. for HB 2194, which modified the benefits and contributions, lifting the cap in FY 2013 and the full actuary contribution rate was contributed ([Attachment 8](#)).

Demographics were provided on salary distribution on local, school, and state employees ([Attachment 9](#)). The demographic information provided on new hires included the age at which they are hired, the male and female ratio; and a list of state and school employees ([Attachment 10](#)).

#### **Commission Review of Alternative Stacked Hybrid Plan Options**

Ms. Beckham and Mr. Banister presented follow up items on the cost of a stacked hybrid plan ([Attachment 11](#)). For the two current studies, Cavanaugh Macdonald was asked to determine the amount of covered wage base that would result in approximately 33.0 percent of total payroll being allocated to the defined contribution plan, then the amount of covered wage base that would result in approximately 66.0 percent of total payroll being allocated to the defined contribution plan. The resulting thresholds for the covered wage base was \$31,000 and \$14,000 respectively. These limits were indexed at 4.0 percent to ensure consistency with the



assumed general wage increase assumption which is part of total salary increase assumption used in the actuarial valuation. Exhibit 1 of [Attachment 13](#) reflects an assumption of 8.0 percent, DC contribution 3.86 percent (employer normal cost under tier 1). Also provided was a distribution of capped salaries for State and School group, based on the DB plan. The Co-chairperson requested a more dynamic model for the December meeting, if this is the direction the Commission is going.

A follow-up of three stacked plan examples of different salaries was presented with the following guidelines ([Attachment 12](#)):

- A 40-year-old earning \$28,150, with a cap of \$30,000, and working from 30 years to 65 years;
- A 40-year-old earning \$29,000, with a cap of \$30,000, and working from 30 years to 65 years; and
- A 40-year-old earning \$32,000, with a cap of \$30,000, and working from 30 years to 65 years.

The Commission requested projections on the Stacked Hybrid Model based on several variables, which included age of employee, employee's length of service, employer contribution rate, employee contribution rate, and investment return. The actuary responded to the Commission with Exhibits 1-19 ([Attachment 13](#)).

The Commission requested the average age of new hires, the average age of separation and information from the 2006 design plan study was provided ([Attachment 14](#)). The average member who terminates (withdraws) membership is 35 to 40-years-old with two to five years of service. The probability of withdrawing appears to correlate more with length of service than age. The highest probability of withdrawing occurs in the first five years of service for all groups. Many KPERS members do not retire from active status. Some leave active status because of death or disability, and thus, still receive KPERS benefits. The largest portion leave due to termination of employment. The likelihood of newly-hired employees retiring from KPERS increases with entry age. The probability of retiring from active status increases significantly after five years of employment. The highest probability of leaving KPERS is a result of termination of employment that occurs in the first five years. Even after this period, many members will not retire from active status.

The Commission followed up with a question and answer session.

Co-chairperson King recessed the meeting until 1:00 p.m.

## **Afternoon Session**

### **Commission Review of Alternative Defined Contribution Plan Options**

The meeting was called to order by Co-chairperson King, and the schedule was reviewed for the next meeting. The Commission continued to review the proposed different scenarios and options for the Defined Contribution plan. The actuary responded to the Commission with Exhibits 20 – 25 ([Attachment 15](#)).

## **Commission Discussion**

Co-chairperson King opened the floor for discussion, comments, and different scenarios the Commission would like to see modeled. The Commission asked Ms. Beckham to quantify any items on the list from the last meeting using Senate Sub. for HB 2194 as the baseline for any cost savings or loss. Ms. Beckham said that could be done for the December meeting.

## **List of Items for Further Study**

The Commission requested Julian Efir, Kansas Legislative Research Department, to review the list of items for further study from the October meeting ([Attachment 16](#)). The list was previously e-mailed to all the Commission members to be reviewed and the list would reflect the intent for further study by the Commission members.

### **Further Study in November-December Meetings**

- Eliminate buyback service credit purchases;
- Refund inactive, non-vested members earlier than five years;
- Eliminate sick and annual leave from pre-1993 calculations for final average salary (FAS);
- Extend vesting from five to ten years;
- Address calculation of legislator's retirement benefits;
- Review Pension Obligation Bonds and bonding; and
- Remove statutory cap on annual KPERS participating employer contributions.

### **Study Developing New Plan Designs**

- Stacked Hybrid; and
- Pure DC.

### **Consider in context of developing new plans**

- Close current plan tier 1 and 2; open tier 3 (undefined);
- Freeze DB plan benefits; replace with new plan (undefined);
- Hard-wire future KPERS state funding;
- Adjust the current 1.75 multiplier to a lower figure; and
- Repeal 2011 Senate Sub. for HB 2194.

There were six recommendations for review by the Legislature or one of its entities:

- Remove the 32-year cap of Kansas Police and Firefighters members;
- Eliminate double-dipping;
- Control or eliminate early retirement incentives;
- Standardize all state retirement plans, including the Regents plan, and make tax treatment consistent for different state plans;
- Prevent spiking in final average salary (FAS); and
- Do not consider excluding legislators from KPERS.

## Commission Discussion and Planning for Future Meetings

The Chairperson stated there have been requests to look at new plan design first at the next meeting. This would inform the Commission on the existing plan.

Ms. Beckham requested further guidelines and asked how complex the cost studies should be on the list of items identified for further study. The Commission indicated there would be no grandfathering; she should assume the system did not exist and do the simplest possible calculation that would give maximum possible cost savings, and the Commission can operate in the parameters of what the actual cost savings would be based on policy. Ms. Beckham asked whether the Commission would like to see bonding reflected in the model for the next meeting. The Commission said they would like to see it, but to take the most simple approach in doing so.

The Co-chairperson opened discussion as to what type of plan the Commission would like to consider at the December meeting. An option would be to remove the vote in Senate Sub. for HB 2194 on the 4.0 percent or 6.0 percent or to leave it at 6.0 percent while waiting for a ruling from the IRS. The Commission requested information on any difficulties KPERS would have in respect to administering the Stacked Hybrid plan. KPERS indicated there would be information available on the administration of the stacked hybrid plan for the December meeting.

Co-chairperson Holmes requested the Commission consider allowing local governments to remain exempt from Senate Sub. for HB 2194 and, if the Commission decides on a pure DC or hybrid, whether a higher match at lower income level would be an option (Attachment 17). The Commission followed up with a question and answer session.

The next meeting was scheduled for December 7-8, 2011. The meeting was adjourned at 3:35 p.m.

Prepared by Connie Burns  
Edited by Michael Steiner and Julian Efirid

Approved by Commission on:

December 7, 2011

(date)