

BEFORE THE SENATE KPERS SELECT COMMITTEE
TESTIMONY ON KPERS MINORITY REPORT
AND SENATE BILL NO. 338

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My name is Rebecca Proctor. I am an attorney specializing in labor law and employee benefits law. I was appointed to the KPERS Study Commission by Senator Anthony Hensley and authored the Minority Report. I appear before you today to discuss the Minority Report and to voice concerns about SB 338.

THE KPERS STUDY COMMISSION

The KPERS Study Commission was established under Senate Substitute for HB 2194 to study and review the current KPERS system and potential defined contribution, defined benefit, or hybrid plan alternatives. The charge given to the Study Commission was to develop a viable plan to insure the long-term sustainability of the system. Those of us signatory to the Minority Report do not feel the plan recommended by the majority of the study commission meets our charge.

THE RECOMMENDED PLAN

The recommended plan was developed and presented by Senator King, and so to separate it from other alternatives, I refer to it as "the King Plan." The King Plan, as presented to the Study Commission, was designed to try to avoid the decreased investment returns which would result from closing the defined benefit plan (as such decreased investment returns increase the actuarial unfunded liability). The intent was also to offset the start-up costs for a defined contribution plan through a lower employer contribution for new employees. The Plan, as presented to the Study Commission, has three components:

- 1) The current KPERS Plan (as revised by Senate Substitute for HB 2194) for current, vested employees;
- 2) A defined contribution plan (401k or 414k) for non-vested employees and new hires that will be funded through the 6% employee contribution;
- 3) A cash balance plan (what Senator King refers to as the annuitization requirement) for non-vested employees and new hires that will be funded through the State's employer contribution.

A cash balance plan is a form of defined benefit plan. Under a cash balance plan, employees are entitled to receive all of the contributions made to the plan on their behalf plus a guaranteed interest rate (which is set by the terms of the plan). The idea behind these plans is that risk is split between the

employee and the plan sponsor. The plan sponsor guarantees that the employee will be protected from any loss; in exchange for that guarantee the employee accepts a lower overall rate of return. If the plan earns more than the guaranteed interest rate, and if the plan overall is financially healthy, all or a portion of the additional income may be awarded to participants as a discretionary dividend. If the plan is not financially healthy, the additional income can be retained by the plan to increase the overall health of the plan (instead of being credited to participants).

Senator King indicated the cash balance portion of his Plan would have a zero percent guaranteed interest rate. So, under the King Plan, new employees would have their own 6% employee contribution going into the defined contribution plan. This contribution would be subject to market gains and losses. The employer contribution (starting at 1% and ramping up to 5% over an eight year period) would go into the cash balance plan. Because of the 0% guaranteed interest rate, the State would not be required to credit any earnings on the employer contributions to the cash balance plan.

Although Senator King referred to this portion of the Plan as an "annuitization account" it is important to recognize it for what it is: a defined benefit cash balance plan. What it really does is create a Tier 3 in the KPERS defined benefit system. Under that Tier 3, the benefit is simply the cash balance in the account, annuitized into a lifetime monthly benefit. Members of KPERS Tier 3 would receive the monthly benefit from the cash balance plan, plus a separate benefit that would be paid from the defined contribution plan.

THE PLAN CONTAINED IN SB 338

The plan contained in SB 338 (hereinafter 338 Plan) is different than the King Plan. It contains the same three components as the King Plan, but adds an additional component. The 338 Plan looks like this:

- 1) The current KPERS Plan (as revised by Senate Substitute for HB 2194) for current, vested employees;
- 2) A 403(b) plan for non-vested public school employees and public school new hires and non-vested community college employees and community college new hires that will be funded by the 6% employee contribution of these employees;
- 3) A defined contribution plan (414k) for all other non-vested employees and all other new hires that will be funded through the 6% employee contribution of these employees;
- 4) A cash balance plan (what Senator King refers to as the annuitization requirement) for non-vested employees and new hires that will be funded through the State's employer contribution.

A 403(b) plan is also known as a tax-sheltered annuity. Only employees of public schools, employees of non-profit organizations, and some ministers

may participate in 403(b) plans. IRS publication #571 lays out details of 403(b) plans for any of you interested in doing additional reading on the subject.

A 403(b) plan is similar to a 401(k) plan, but they are NOT the same.

For the most part, 401(k) plans are not limited in what they can invest in. 403(b) plan participants are limited to investing in annuities (either fixed or variable) or mutual funds in custodial accounts with a registered investment company.

It is important to know/remember that annuity contracts have their own terms and conditions. So, let's say a public school employee invested in an annuity contract. Then, the KPERS Board decided to change investment providers. The money the public school employee invested in the annuity contract would not automatically move when the plan changed investment providers. Each participant investing in an annuity contract would have to individually move the money over to the new provider.

This also means the plan administrator (be it the KPERS board or a third-party administrator) would have to review the various annuity contracts in order to properly administer the overall plan.

THE 338 PLAN IS NOT CONSISTENT WITH THE COMMISSION'S RECOMMENDATION

I was a member of the KPERS Study Commission and did not miss a single Commission meeting. The Study Commission NEVER discussed or voted on the general concept of breaking out one group of KPERS participating employees into a separate plan. The Study Commission also NEVER received information or testimony regarding 403(b) plans. The Study Commission had specific discussion that ALL State employees, including legislators, should be treated the same. The 338 Plan does not hold to that principle.

Under the 338 Plan, public school employees and community college employees are treated differently than other state employees. These employees will participate in a different defined contribution plan, with different investment options, different rules, and potentially higher administrative costs. The costs are very relevant, because the 338 Plan charges all administrative fees for the defined contribution accounts back to the employees (something else the Study Commission never discussed). The 338 Plan will also allow the public school and community college employees to make additional elective deferrals to their defined contribution accounts; state employees in the 414(k) plan will not have this option.

I am unsure how the Study Commission's philosophical jumping off point, that all State employees should be treated the same, resulted in a bill that treats some employee groups differently.

Additionally, the 338 Plan handles the cash balance plan differently than described by Senator King during the Study Commission meetings. Senator King, both during Study Commission and at the joint meeting of the Senate and House Pension Committees, described a plan where although the guaranteed rate of return was set at 0%, the actual earnings/losses would be tracked. Then, at retirement, the employee would receive an interest credit equal to the actual earnings/losses over the life of the account (with the exception that the employee would be guaranteed never to receive less than the actual dollar value of contributions that were deposited into the account). The minority report expressed concern that this could not be done as the benefit would no longer be defined.

The 338 Plan tries to fix this issue. Under the 338 Plan, every year the employee will receive a 0% interest credit for the guaranteed interest rate and then a supplemental interest credit that will match the performance of the plan. The supplemental interest credit may be positive or negative, meaning the employee account will mirror the Plan's actual performance. However, the employee will still be entitled to receive not less than the dollar amount of employer contributions at retirement.

This is a very odd way to run a cash balance plan. Cash balance plans (as described above) are generally the middle ground between a pure defined contribution plan and a pure defined benefit plan. This design eliminates the benefit the plan sponsor would usually have of being able to use additional earnings over the guaranteed rate to improve the overall health of the plan. The idea of the cash balance plan is that the employee will always know

I cannot provide any specific cost numbers regarding the 338 Plan because, as far as I know, no analysis has been done regarding adding the 403(b) component. I can say that it adds yet more complexity to what was already a rather complex and convoluted plan design and certainly will not do anything to reduce the State's cost or the UAL. The King Plan, even without the 403(b) component, already increased costs.

THE KING PLAN COSTS MORE THAN 2194

KPERS Plan Actuary Pat Beckham presented projections regarding the costs of the King Plan on January 24, 2012. Ms. Beckham's presentation stated the cost of the 2194 Plan as \$22.14B (for years 2012 through 2060). The cost of the King Plan is \$33.04B (for years 2012 through 2060). This is a \$10.9B difference (and again, this does not include any potential start-up or maintenance

costs for the 403(b) component). There is no reason to adopt a plan that adds this kind of costs to the system.

THE KING PLAN DOES NOT ADDRESS THE UAL

The King Plan contains no components designed to address or reduce the UAL. When discussing the King Plan with the Study Commission on the afternoon of December 7, 2011, Senator King said:

...there are three general aspects we are tasked to look at: the UAL, making sure that future generations of Kansans, employees, and taxpayers are not where we are now, and making sure we provide the best affordable benefit that we can for KPERS eligible employees. The Plan I talked about this morning does not address the first issue. It is not going to dig us out of this hole.

By Senator King's own admission, this Plan does nothing to address or confront the UAL. The UAL is the primary motivating factor behind discussions to modify the current system. Adopting a plan which does nothing to address the UAL is simply change for the sake of change.

By contrast, the changes HB 2194 makes to the KPERS system directly address the UAL. As Representative Trimmer told the Study Commission:

Yes, we pay a lot in to KPERS and that amount will get higher before it gets lower. That is true regardless of what system we use. The difference is we pay more in the short-term and in the long-term with the defined contribution plan. A defined contribution system, as opposed to 2194, costs us more in the short-term and the long-term and provides lower benefits to the employee. No matter what we talk about, those two things are still true. The best system we have on the table is the system in 2194 which makes us pay the actuarial required rate and will eventually lower the cost in the future, which the defined contribution plan does not do.

It makes no sense to those of us in the minority to add costs to the system if those costs do not help reduce the UAL or increase employee benefits.

Although the 338 Plan contains some additions to the King Plan, it also does not contain any components to address the UAL.

NEITHER THE KING PLAN NOR THE 338 PLAN PROVIDES AN ADEQUATE BENEFIT

One of the things that is most troubling to me about the King Plan and the 338 Plan is that under either, it is very difficult for an employee to

anticipate/calculate what benefit will come out of the cash balance plan. As an overall note, this is not at all consistent with the usual operation of a cash balance plan, where the amount that will come out at the end is easily calculated.

Both the King Plan and the 338 Plan contain the same provision for annuitizing the cash balance at retirement: the annuity conversion rate will vary because it is based on the PBGC Distress Termination Interest Rate. As covered in Pat Beckham's presentation last week, that rate changes monthly.

The graph on page 27 of Ms. Beckham's presentation shows the impact the interest rate has on the monthly benefit. Using her example, if a \$300,000 account balance is converted to a monthly annuity for a 65-year old, a 3.5% interest rate will result in around a \$1700.00 monthly annuity; if the interest rate is 6.5%, the monthly benefit changes to around \$2400.00.

Since this interest rate changes monthly, there is no way an employee can have any way to project what the benefit will be at retirement. It also makes it very difficult for an employee to determine when to retire, as future conversion rates are unknown.

This is not how a cash balance plan is supposed to work. Under a more standard cash balance plan formulation, both the guaranteed interest rate and the annuity conversion rate are a set. This allows the employee and the plan sponsor to know, based on the account balance, precisely what the retirement benefit would be upon conversion.

I know that during Pat Beckham's presentation last week, she reviewed some benefit comparison charts. The income replacement numbers on that chart look pretty favorable, until you start looking at and considering the assumptions. Those charts make the following assumptions: The DC Plans will earn 8%, the cash balance plan will have an annual interest credit of 8%, and the annuitization rate will be 6.5%.

As Ms. Beckham stated, the numbers change if any of the assumptions are not met. Both DC components are set up as self-directed accounts where employees will make their own investment choices. Keep in mind that when the replacement ratios are modeled under 2194, KPERS' historical rates of return are used to determine the interest earning assumption of 8%.

On the defined contribution plan front, an 8% return is generally considered a fair estimate for aggressive investors, 6% for moderate investors, 4% for conservative investors. An 8% return assumes employees will have the risk tolerance necessary to invest aggressively. In reality, this isn't the case. Examples establishing this point from West Virginia and an Employee Benefit Research Institute study are included in the minority report.

Today I will add another example: Nebraska. Nebraska made the decision to move from a defined contribution plan to a cash balance plan. Nebraska ran its defined contribution plan from 1967 through 2002. A state study conducted by Nebraska in 2000 found that over thirty years, the typical worker in the defined contribution plan received an average annual return of 6-7%. The total contribution (employee and employer) was around 10-11%.

Nebraska gave employees lots of tools to help them invest wisely. Nebraska gave workers time off from work to attend daylong educational seminars about the stock market. The state offered eleven fund choices to allow workers to diversify; 90% of the money went into only three funds.

Nebraska did a lot of work to provide good investment options and to make sure employees were educated about those options. Despite all of that work, Nebraska still ultimately concluded that the defined contribution plan did not provide enough benefit for the cost. In fact, the Nebraska plan administrator at the time of the conversion stated that the defined contribution plans performed so poorly they were a waste of taxpayer resources.

During the Study Commission meetings, we heard a lot of testimony about the types of returns that are theoretically possible with a defined contribution plan. I would agree that theoretically, defined contribution plans can produce very good returns. However, in reality, those kind of returns are the exception, not the rule.

Neither the King Plan, nor the 338 Plan, provides employees the kind of educational tools that Nebraska provided. Yet there is still the assumption that employees will self-direct their investments for an 8% return. The assumption is simply not realistic.

As Kansas looks at its retirement systems, it should learn from the mistakes other states have made. The King Plan and the 338 Plan do not heed those lessons, but push Kansas into those same mistakes.

CONCLUSION

As I wrote in the minority report, the King Plan increases costs to the system and reduces employee benefits while doing nothing to address the UAL. The 338 Plan adds yet another benefit plan for the State to administer, while also adding costs to the system and not addressing the UAL.

There is no logical reason to adopt either of these plans, and neither fulfills the charge the Study Commission was given to recommend a viable plan to insure the long-term sustainability of the KPERS system.

