

## House Bill 2217 – Summary of KPERS Considerations

HB 2217 creates an optional defined contribution retirement plan, the Kansas Thrift Savings Plan, for new members and allows for existing members to make a one-time election into the new plan. The new plan is available to all three KPERS groups (KPERS, KP&F and Judges).

### Defined Benefit vs. Defined Contribution

Defined Benefit Plans	Defined Contribution Plans
Employer bears most of the risk (i.e. investment, inflation risk, longevity risk)	Employee bears all of the risk
Pooled assets, institutional investing, lower fees	Individual accounts, fewer investment options available to participants, higher fees
Employer contributions are variable depending on plan experience	Employer contribution is fixed
Guaranteed lifetime benefit at retirement	No benefit guarantees
Non-portable (only member contributions and interest can be withdrawn or rolled over to another account)	Portable (all vested contributions and interest can be withdrawn or rolled over to another account)

### Governmental Defined Contribution Plans

Several states offer defined contribution plans for all or a portion of public employees. However, defined benefit plans are still the most common governmental plans.

### Kansas Thrift Savings Plan Structure in HB 2217

New employees have 14 days to elect into the Thrift Savings Plan or into the existing defined benefit plan. If there is no election, the new employees defaults into the defined benefit plan.

Existing KPERS members will be allowed to elect into the Thrift Savings Plan if allowed by the Internal Revenue Service. Member who elect to switch plans would have an amount equal to the actuarial value of their benefit transferred into their Thrift Saving Fund account.

The structure of the plan includes:

Employee contributions	3% minimum, voluntary contributions allowed Contributions can be Roth (post-tax) or pre-tax
Employer contributions	4% minimum 4.5% if employee contributions 4% 5% if employee contributes at least 5%
Employee vesting	Immediately vested in employee contributions and interest Vested in employer contribution after 5 years
Investment options	Employee selects investments from investment options selected by the Board of Trustees
Withdrawals	Employee can apply for withdrawal at any point after terminating employment.

### Legal Considerations

- *One-time election for current members.* The structure in HB 2217 is not allowable under Internal Revenue Service (IRS) regulations. It is not clear if the IRS will allow any election for current members.

- [\*Definition of first employed\*](#). The bill includes inactive, non-vested members in the definition of first employed. However, these members already have membership in the defined benefit plan. This appears to create a de facto election that would not be permissible by the IRS.
- [\*Option employee contributions\*](#). HB 2217 allows employees to make voluntary contributions in addition to the mandatory 3%. However, the Thrift Savings Plan would be organized under section 401 of the Internal Revenue Code, which does not allow for voluntary contributions. It is possible to structure the Thrift Savings Plan to allow for voluntary employee contributions with additional clarification.

### **Funding Considerations**

- [\*Unfunded actuarial liability contributions\*](#). HB 2217 does not include employer funding for the existing unfunded actuarial liability on the defined contribution payroll. The unfunded liability is a debt of the state that must be funded, losing employer contributions on a portion of existing payroll would likely increase required employer contributions in the defined benefit plan.
- [\*Asset allocation/Investment returns\*](#). HB 2217 is potentially disruptive to the cash flow of the defined benefit plan. This is especially likely if existing members are allowed to transfer in and a large portion of assets is transferred out of the KPERS Trust Fund. Changes to cash flow and required cash reserves will impact the investment allocation and negatively affect investment return potential.
- [\*Long-term employer costs\*](#). The Thrift Savings Plan has a minimum employer contribution of 4%. The KPERS 3 cash balance plan has an employer normal cost of less than 1% as it is currently structured. After the unfunded actuarial liability is funded the employer cost for the Thrift Savings Plan is projected to be higher than the existing defined benefit plan.

### **Administrative Considerations**

- [\*Startup costs\*](#). The KPERS Trust Fund can only be used for the benefit of member of the defined benefit plan. Using trust fund assets to start an alternate defined contribution plan is not allowed under trust law. An alternative funding source, like the State General Fund, would have to be used in order to start the program.
- [\*Death and disability coverage\*](#). If the defined contribution plan is administered by a third-part administrator (like the KPERS 457 plan is administered), would these members be covered by the State death and disability plan? If so, how will the relevant data and contributions be made to KPERS?
- [\*One-time election for current members\*](#). KPERS has more than 150,000 active members today. Allowing for a one time election would be a significant undertaking that will require appropriate time and resources to complete.

### **Administrative Costs**

- [\*Staffing\*](#). KPERS estimates it will take 16 employees during the transition years (FY 2021, FY 2022 and FY 2023) for member and employer education, plan startup, and plan management. After the transition, the full time staffing is estimated to be 7 positions for plan management, fiscal monitoring, and member and employer support.
- [\*Information Technology\*](#). KPERS information technology system would need to be updated to handle the new election information and accurately tracking members who elect into the Thrift Savings Plan or the defined benefit plan. There would also be information technology costs for new computers and equipment for the additional staff positions.

## MEMORANDUM

To: House Financial Institutions and Pensions

From: Alan D. Conroy, Executive Director

Date: March 13, 2019

Subject: HB 2217; Kansas Thrift Savings Plan

HB 2217, the Kansas Thrift Savings Plan Act, creates a defined contribution plan and makes it available as an optional retirement plan for all three Retirement System membership groups (KPERs, KP&F and Judges). The existing defined benefit plans remain open to new members. However, new members will make a one-time, irrevocable election into either the defined benefit or the defined contribution 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 of 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 without penalties.

### **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 414(d) of the internal revenue code.

Governmental defined contribution plans are not particularly rare. Several states, including Alaska, Michigan, Minnesota, Utah and West Virginia, have defined contribution plans as a primary retirement plan. Another seven states, Colorado, Florida, Indiana, 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**

HB 2217 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*

HB 2217 makes the Kansas Thrift Savings Plan an optional primary plan for members. Newly hired members have 14 days to make an election into either the existing defined benefits plan or into the Kansas Thrift Savings Plan.

Members failing to make an election within 14 days are automatically enrolled into the existing defined benefit plan. Members who are automatically enrolled in the defined benefit plan are considered to have made an irrevocable election.

#### *Member Accounts and Contributions*

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

1. Member mandatory contribution account. Each member is required to contribute a minimum of 3%. Additional voluntary contributions are allowed. 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. Employer contribution account. 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 4% of pay and 5% if the member contributes 5% of pay. The member vests in the employer contribution account after five years of participating service in the Thrift Plan.
3. Rollover account. HB 2217 requires the plan to accept rollovers 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. HB 2217 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

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. However, the option to receive monthly income, guaranteed for life, is not available in a defined contribution plan. As a result, the individual employee entirely assumes both the longevity and post retirement inflation risk.

If a member 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*

HB 2217 allows for one-time, irrevocable election of all existing KPERS members (KPERS State, KPERS School, KPERS Local, KP&F and Judges) to switch to the Kansas Thrift Savings Plan, if allowed by the Internal Revenue Service (IRS). 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 bill also provides that the full amount of the present value of the member's accrued benefit will be transferred to the rollover account in the defined contribution plan. Because the rollover

account is fully vested, a member who is not vested in the defined benefit plan would effectively “vest” if he elected to participate in the defined contribution plan. If that is not the intent of the legislation, additional clarifying language will be necessary.

The election section of HB 2217 is severable from the rest of the bill if the IRS does not approve of the election. For legal reasons discussed later in this memorandum, IRS approval of this election is unlikely.

### **Legal Considerations**

After reviewing language in HB 2217 and discussing the proposal with KPERS’ outside tax counsel (Ice Miller), there are a couple of legal issues that would need to be addressed in the bill language.

#### *One-Time Election for Current Members*

Section six of HB 2217 allows for current members to elect to move from the existing defined benefit plan to the Kansas Thrift Savings Plan. However, the required employee contribution rate for the defined benefit plan is 6% (7.15% for KP&F) while the required contribution rate for the thrift savings plan is only 3%. This difference in required contribution creates what the Internal Revenue Service labels a cash or deferred arrangement, which is impermissible. For that reason, we believe that the current structure of the election in section six of HB 2217 would not be approved by the Internal Revenue Service.

In addition, over the past several years the Internal Revenue Service has consistently ruled against, or failed to offer any ruling, regarding individual member elections in governmental pension plans. This leads us to believe that any election language is unlikely to receive Internal Revenue Service approval.

#### *Definition of First Employed*

In the definitions section of HB 2217, “first employed” is defined as including any member who is an inactive, non-vested member. Section five of the bill allowed employees who are first employed after July 1, 2022, to elect to participate in the defined benefit plan or the Kansas Thrift Savings Plan.

However, these inactive, non-vested members are already KPERS members and allowing them an election into the thrift plan in the future creates an impermissible cash or deferred arrangement for that group of employees and would not be allowed by the Internal Revenue Service.

Section 6(d) provides that a member in either plan who becomes inactive after an election and return to active membership remains in the plan previously elected, unless the member returns to active membership with a different participating employer, in which case the member becomes a member of the Thrift Savings Plan. This could effectively switch a member’s retirement plan coverage simply by changing employment, when both employers are KPERS participating employers. It is not clear if this would be allowed by the Internal Revenue Service and may require additional clarifying language.

### *Optional Employee Contributions*

HB 2217 requires employees to contribute 3% of compensation, but allows for additional contributions. However, if the Kansas Thrift Savings Plan is organized under section 401 of the Internal Revenue Code, optional employee contributions are not permitted.

Voluntary contributions are allowed under other sections of the Internal Revenue Code, such section 457 (which governs the KPERS 457 plan). It is likely possible to structure legislation in a way that allows for voluntary additional employee contributions, but the current bill language does not appear to allow such contributions.

### **Funding Considerations**

HB 2217 creates an optional, parallel retirement plan for members hired after June 30, 2022. Given the benefit structure of the defined benefit plan for KP&F and Judges, we do not expect many new hires will elect coverage in the Thrift Savings Plan. However, the lower employee mandatory contribution in the Thrift Plan, coupled with a higher initial employer contribution, will likely result in a high election into the defined contribution plan for KPERS members. This will effectively change the pool of employees that are enrolled in the existing defined benefit plan over time which can impact the long-term funding of the KPERS Trust Fund.

### *Unfunded Actuarial Liability Contributions*

HB 2217 does not include a provision that requires employers to continue making contributions towards the existing unfunded actuarial liability if employees are covered by the Thrift Savings Plan. Therefore, the covered payroll base of the defined benefit plan would be expected to erode over time. How rapidly this occurs is directly related to the new member election rates into the Thrift Savings Plan. Due to the expected decline in the covered payroll of the defined benefit plan, the current actuarial assumption, which anticipates increases in the annual covered payroll, would likely be changed, resulting in an increase in the employer contribution rates for the defined benefit plan. With the statutory cap, this might result in actual contribution less than the actuarial rate for several years and corresponding increases in the unfunded actuarial liability.

### *Asset Allocation/Investment Returns*

In a mature, open defined benefit plan, like KPERS, it is common for benefit payments to exceed contributions, in other words it is common for a mature defined benefit plan to be cash flow negative. This is normal and manageable with proper planning and management. However, with reduced cash flow, the gap between benefits and contributions would increase and could potentially grow past a range of stable cash flow.

As a result, the portfolio's asset allocation would need to shift to more liquid investments to meet the cash flow needs of the System. This shift would have a negative impact on potential investment returns and could require a reduction in the investment return assumption, resulting in increases in the employer contribution rates.

Over time, the less funding for the defined benefit plan that can be achieved through investment returns has to be made up through higher future employer contributions.

### *Anti-Selection of the Defined Benefit Plan*

HB 2217 requires employer contributions of 4%. The current required employer contributions in the defined benefit plan total 13.21% for KPERS State/School, 8.89% for KPERS Local, 20.09% for KP&F and 14.68% for Judges.

The large difference in required employer contributions could create an environment where it is in the employer's best interest to have members enroll in the Kansas Thrift Savings Plan, regardless of what is best for the employee. The difference is particularly large in the public safety retirement plan (KP&F) where the difference in contributions is over 15% of pay although it is less likely these members would elect into the Thrift Savings Plan.

With KPERS' current substantial unfunded actuarial liability, more employees electing the thrift plan means a larger potential for negative effects on the overall funded status of the System.

### *Long-Term Employer Normal Cost*

In 2012, the Legislature created a new cash balance plan for KPERS members hired on and after January 1, 2015 (KPERS 3). The cash balance plan design is a less expensive plan design than the traditional defined benefit plan. The current estimated normal cost for the cash balance plan is between 6%-7%. Since employees contribute 6% to the normal cost, the employer normal cost for the cash balance plan, over the long-term, is expected to be less than 1%.

The required employer contribution in the Kansas Thrift Savings is a base of 4%. The required matching component could also push the rate slightly higher. Over the long-term, the employer costs are projected to be higher under the Kansas Thrift Savings Plan than under the current cash balance plan.

This is less of a consideration for the KP&F and Judges plans, where the normal cost is quite a bit more.

### **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.

HB 2217 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 electing 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.

#### *Death and Disability Coverage*

One major issue that is not addressed in HB 2217 is death and disability coverage. The death and disability plan is administered by KPERS and funded by employers through a 1% payroll contribution.

Because all members currently enter the defined benefit plan, KPERS has access to all relevant payroll information necessary to administer the death and disability plan. If a group of members is allowed to elect into the Kansas Thrift Savings Plan, the following questions would need to be addressed:

1. Are Kansas Thrift Savings Plan Members covered by the State's death and disability plan?
2. Will KPERS administer the death and disability plan for all employees, including those in the Kansas Thrift Savings Plan?
3. If so, how will Kansas Thrift Saving Plan member payroll information be reported to KPERS?

If thrift plan members will be covered by the State death and disability plan, it can be accomplished. However, KPERS will need additional direction to carry out the policy intent.

#### *One-Time Election for Current Members*

Having an election for current members to switch from the defined benefit plan to the Kansas Thrift Saving Plan would require significant administrative effort for KPERS.

With over 150,000 active KPERS, KP&F and Judges members working at approximately 1,500 employers the amount of education required is extensive. Efforts would include both electronic and published educational campaigns, online calculators, and additional staffing to answer member phone calls and employer questions.

The administrative effort would be time limited as HB 2217 specifies that there will be a single window of time that current members will be allowed to make the election. However, it would be a time- and resource-intensive project to complete.

As mentioned earlier, for legal reasons it is unlikely the Internal Revenue Service will approved a one-time election for existing members.

### **Administrative Costs**

Establishing a defined contribution plan will entail a range of administrative costs and will require establishing additional internal controls and accounting mechanisms to ensure that the assets of the defined benefit trust and the defined contribution trust are used exclusively for the benefit of the members of each trust.

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.

The following cost estimates assume that Kansas Thrift Savings Plan will be administered by a third-party administrator and that the election for current members to elect to switch from the defined benefit plan to the thrift plan would not be allowed by the Internal Revenue Service.

### *Staffing*

KPERS estimates that it would require 16 additional staff positions during the transition period. After the transition period, seven of those positions would be required for the ongoing administration of the Kansas Thrift Savings Plan.

The staffing costs would ramp up starting in FY 2021 for the start date of the Kansas Thrift Savings Plan of July 1, 2022. The annual salaries and wages estimate for the transitional years (FY 2021, FY 2022, and FY 2023) is approximately \$825,000 for 16 employees (i.e. plan startup, employer support, benefits representatives, and plan management).

Ongoing staffing salaries and wages (starting in FY 2024) are estimated to be about \$565,000 per year for 7 employees (i.e. plan management, fiscal monitoring and member education and support).

### *Information Technology*

Information technology costs associated with the implementation of HB 2217 fall into two categories: upgrades to KPERS' information technology system and additional information technology hardware and software for new employees.

Assuming that a third-party administrator will be responsible for all of the tracking of member data, changes to KPERS information technology system will be necessary to ensure that KPERS information technology system can properly interface with the third-party administrator whenever data sharing is necessary. The total cost estimate for changes to the existing information technology system is about \$200,000. This work would have to be completed prior to the implementation of the Kansas Thrift Savings Plan and would likely occur in FY 2022 (July 1, 2021 to June 30, 2022).

Information technology costs for additional staffing include things like computer hardware, computer software and ongoing licenses, and phone and internet connections.

### **Conclusion**

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

HB 2217 provides a general framework for creating the Kansas Thrift Saving Plan. However, some changes and additional language may be necessary to pass muster with the Internal Revenue Service and to ensure the long-term funding needs of the existing defined benefit plans are met.

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