Division of the Budget
Landon State Office Building
900 SW Jackson Street, Room 504
Topeka, KS 66612

Kansas
Division of the Budget

Phone: (785) 296-2436
adam.c.proffitt@ks.gov
http://budget.kansas.gov

Adam C. Proffitt, Director

Laura Kelly, Governor

February 16, 2024

The Honorable Nick Hoheisel, Chairperson
House Committee on Financial Institutions and Pensions
300 SW 10th Avenue, Room 582-N
Topeka, Kansas 66612

Dear Representative Hoheisel:

SUBJECT: Fiscal Note for HB 2619 by Representatives Penn and K. Williams

In accordance with KSA 75-3715a, the following fiscal note concerning HB 2619 is respectfully submitted to your committee.

A Deferred Retirement Option Plan (DROP) is a retirement plan design feature where a KPERS member initiates the calculation of a retirement benefit, but choses to defer actual receipt of the benefit for a specified period. During this specified DROP period, the member continues working and the member's benefit is credited to a notional account and is eventually made available in a lump sum when the member ultimately leaves employment. Currently, this feature is only available to members of the Kansas Police and Firemen's (KP&F) retirement system.

Under the current plan, when an eligible member is eligible for normal retirement, the member can elect a three, four, or five-year DROP period with the approval of their employer. Members can elect to extend their initial DROP period, but the total DROP period cannot exceed 5 years. During the DROP period, the member's benefit accrues in their notional account and may earn 3.0 percent interest in a calendar year when the KPERS' investment return reaches the 7.0 percent investment return assumption. At the end of the DROP period, the member receives the DROP account balance in a lump sum or rollover to another qualified plan. The current DROP program has a sunset date of January 1, 2031. HB 2619 would expand the DROP plan design to all KPERS employers.

According to KPERS, HB 2619 would allow eligible members to participate in DROP when they become eligible to retire with unreduced benefits (normal retirement), as follows:

- Members hired prior to July 1, 2009, could elect to participate in the DROP upon attainment of age 65 and completion of one year of credited service; at age 62 and completion of ten years of service; or at the attainment of age and years of service totaling 85 points, regardless of the age of such member;

- Members hired on or after July 1, 2009, could elect to participate in DROP upon attaining age 65 and completion of five years of credited service; or at age 60 and completion of 30 years of creditable service; and
- Correctional members could participate in the DROP at the attainment of normal retirement date (either age 55 or age 60 depending on the group).

The actuarial cost of extending the DROP to all KPERS members would be dependent on the changes in the retirement decisions of the members who are eligible for the DROP, which is difficult to estimate. In general, the value of a member's retirement benefit is greater at the point the member first becomes eligible for unreduced retirement benefits (normal retirement) than at a later date when retirement has been delayed for a period of time after reaching normal retirement age. As a result, plan design changes that provide incentives for members to begin receiving benefits earlier than under current actuarial assumptions tend to increase a retirement system's actuarial liability and costs. Plan design changes that provide incentives for members to delay receipt of benefits beyond existing actuarial assumptions may tend to reduce the retirement system's actuarial liability and costs. The potential cost of expanding the DROP to KPERS depends in part on how the DROP would affect a member's retirement decisions.

Based on the KPERS benefit structure and the actuary's experience with DROP programs in other systems, KPERS notes that expanding the current DROP to all KPERS members could incent different types of behavior from different members, including: (1) working longer than they do now; (2) leaving at about the same time as they do now after entering DROP in anticipation of that retirement date, or (3) delaying the age at which they ultimately leave covered employment. These outcomes have different costs, but it is not possible to know which will occur. As a result, the cost analysis from the actuary includes these three alternate sets of DROP retirement assumptions to illustrate the effect of different member behavior on the contribution rate and funded status, as shown below. The actuary's reference to "retirement rates" is the age at which the member ultimately leaves covered employment, whether DROP was elected or not.

- **Scenario 1:** assumes the current retirement rates would not change. Active members would be assumed to elect to participate in the DROP if they are eligible and the value of the DROP benefit is higher. Benefits would be assumed to commence immediately for members who retire if the value of doing so is greater than the value of the DROP benefit. The ultimate age of retirement would be unchanged with this scenario, as DROP would be elected in anticipation of leaving employment at the same date as retirement would have occurred without the DROP.
- **Scenario 2:** assumes the retirement rates would be unchanged from the current assumption through five years after a member's normal retirement age. At this point, 100.0 percent of members would be assumed to begin receiving benefits and would reflect that the DROP would motivate earlier retirement for those who were expected to remain employed more than five years beyond normal retirement.

- **Scenario 3:** assumes the retirement rates at normal retirement age and four years after are lowered by 50.0 percent. This would reflect the effect of many members choosing to delay the age when they would leave covered employment.

  Based upon these scenarios, the following have been calculated by the actuary:

State/School Group Scenarios
(Dollars in billions)

	12/31/2022 Valuation (Baseline)	DROP Scenario 1	DROP Scenario 2	DROP Scenario 3
Total Actuarial Liability	$ 24.29	$ 25.21	$ 25.65	$ 25.09
Actuarial Value of Assets	18.03	18.03	18.03	18.03
Unfunded Actuarial Liability (UAL)	$ 6.26	$ 7.18	$ 7.62	$ 7.06
Funded Ratio	72.4 %	71.5 %	70.3 %	71.9 %
Normal Cost Rate	8.81 %	8.91 %	8.97 %	8.80 %
Employee Contribution Rate	-6.00 %	-6.00 %	-6.00 %	-6.00 %
Subtotal—Employer Normal Cost Rate	2.81 %	2.91 %	2.97 %	2.80 %
UAL Payment	8.75 %	10.14 %	10.80 %	9.93 %
Total Employer Contribution	11.56 %	13.05 %	13.77 %	12.73 %
Change from Baseline	--	1.49 %	2.21 %	1.17 %

Local Group Scenarios
(Dollars in billions)

	12/31/2022 Valuation (Baseline)	DROP Scenario 1	DROP Scenario 2	DROP Scenario 3
Total Actuarial Liability	$ 7.02	$ 7.36	$ 7.54	$ 7.32
Actuarial Value of Assets	5.07	5.07	5.07	5.07
Unfunded Actuarial Liability (UAL)	$ 1.95	$ 2.29	$ 2.47	$ 2.25
Funded Ratio	72.2 %	68.9 %	67.2 %	69.2 %
Normal Cost Rate	8.07 %	8.17 %	8.22 %	8.10 %
Employee Contribution Rate	-6.00 %	-6.00 %	-6.00 %	-6.00 %
Subtotal—Employer Normal Cost Rate	2.07 %	2.17 %	2.22 %	2.10 %
UAL Payment	7.53 %	8.86 %	9.56 %	8.72 %
Total Employer Contribution	9.60 %	11.03 %	11.78 %	10.82 %
Change from Baseline	--	1.43 %	2.18 %	1.22 %

As shown in the above tables, if members leave covered employment at the same age as expected with the current assumptions, but simply elect the DROP before leaving, the costs are estimated to increase by 1.49 percent of payroll for the State/School Group and by 1.43 percent of payroll for the Local Group. If the DROP provision would result in members ultimately leaving covered employment earlier, the cost would be higher, estimated at 2.21 percent of payroll for the State/School Group and 2.18 percent of payroll for Local Group. If the DROP provision would result in members ultimately leaving covered employment later, the cost would be the lowest of the three scenarios, estimated at 1.17 percent of payroll for the State/School Group and 1.22 percent of payroll for the Local Group.

To translate these additional percentages into costs, the KPERS actuary estimates that the enactment of the bill would require an additional $63.7 million to $120.4 million from all funding sources in FY 2025 for the State/School Group employer contributions for the range of the scenarios. Assuming that approximately 85.0 percent of the State/School Group payroll is financed from the State General Fund, this would result in additional costs of $54.1 million to $102.3 million from the State General Fund. For FY 2026, the range would be estimated from $64.9 million to $122.6 million from all funding sources, including $55.2 million to $104.2 million from the State General Fund, using the same assumption of 85.0 percent of the State/School payroll being funded from the State General Fund. For the Local Group, additional employer contributions in calendar year 2025 are estimated to increase between $25.2 million and $45.1 million. For calendar year 2026, additional employer contributions are estimated to increase between $25.7 million and $45.8 million.

KPERS reports that adding a deferred retirement option program to the current plan design would be a new benefit for active KPERS members. The agency reports that there were 143,849 active KPERS members as of December 31, 2022, and approximately 15,000 active members who met the eligibility for normal retirement and would be immediately eligible to enter the DROP. The number of active members in KPERS is nearly 20 times larger than the number of active members in the KP&F plan, which currently has a DROP option. The agency would anticipate that adding the DROP to the KPERS plan design would generate additional questions from members and employers. Members and employers likely would have questions on what the DROP is and how it works. Members likely would also question how their benefits would be affected by electing to participate in the DROP.

Because of the increase in inquiries and benefit calculations expected, KPERS indicates that the enactment of the bill would require additional employees for the Benefits and Member Services division and the Fiscal Services division. KPERS estimates an additional 8.00 FTE positions (6.00 FTE positions in Benefits and Member Services and 2.00 FTE positions in Fiscal Services) would be necessary. The total salaries and wages for these 8.0 positions totals $597,371 in FY 2025 and $622,485 in FY 2026 based on the current position pay rates and budget indices for fringe benefits.

In addition to the additional staffing requirements, the KPERS pension administration system would need to be updated to accommodate DROP for KPERS employers. DROP would affect several modules within the pension administration system and is estimated to require approximately 2,000 hours of development and testing. The pension administration system work would need to be completed in FY 2024 to be ready for the DROP to go into effect on July 1, 2024, which would be the effective date of the bill. The cost estimate for the information technology work is $328,020, all from the KPERS Fund. Any fiscal effect associated with HB 2619 is not reflected in *The FY 2025 Governor's Budget Report*.

Sincerely,

Adam C. Proffitt
Director of the Budget

cc: Jarod Waltner, KPERS