AUDIT PROPOSAL

Reviewing the KPERS 3 Retirement Plan

SOURCE
This audit proposal was suggested by Representative Nick Hoheisel and KPERS staff to satisfy requirements in K.S.A. 46-1136.

BACKGROUND
The Kansas Public Employees Retirement System (KPERS) administers several retirement plans for state and local employees. The plan an employee belongs to depends on when they were hired and what type of position they’re filling. State, local, and school employees (not police, fire, or judges) belong to KPERS 1, KPERS 2, or KPERS 3. The three plans work similarly but have some key differences such as the guaranteed minimum annual interest on contributions. As of December 31, 2021, nearly 68,000 (47%) of the plan’s active members belonged to KPERS 3. Employees in this plan were hired after January 1, 2015.

KPERS 3 is a cash balance plan that is designed to provide lifetime benefits like KPERS 1 and KPERS 2 but has characteristics of a contribution plan like a 401(k) or 403(b) plan. It provides benefits based on an employee’s career average salary and includes mechanisms for sharing risks between the employer and the employee. Generally, KPERS 3 provides a lower level of benefits than KPERS 1 or KPERS 2. The cost of KPERS 3 is lower than KPERS 1 and KPERS 2. However, a single employer contribution rate for all active members is calculated for funding purposes.

The legislature created KPERS 3 after the 2008 recession to improve the long-term sustainability of KPERS. One of the policy goals at that time was to create a benefit structure that would reduce the future costs of retirement benefits. KPERS 3 accomplishes that, but it also reduces the percentage of an employee’s pre-retirement income that will be replaced by retirement benefits. Studies suggest employees should target a replacement ratio of 70-80% of their pre-retirement income to maintain their lifestyle in retirement. According to estimates from KPERS and their actuaries, a career employee (someone who works 30 years between the ages of 35 and 65) would have a replacement ratio of 27%-34% on the KPERS 3 plan. Social security is typically assumed to replace 30% of pre-retirement income.

In recent years, the legislature has considered several potential changes to the KPERS 3 plan as it considers whether it’s providing sufficient retirement benefits to public employees at a reasonable cost. For example, it’s considered converting KPERS 3 to a 401(k) plan, eliminating KPERS 3 and moving members to the KPERS 2 plan, or creating a new defined contribution plan called a thrift savings plan. Stakeholders have expressed interest in understanding how the KPERS 3 plan compares to other plan designs in the marketplace and stakeholders’ opinions on things like the sufficiency of the KPERS 3 plan and its impacts on employee recruitment and retention.
AUDIT OBJECTIVES AND TENTATIVE METHODOLOGY

The audit objectives listed below are the questions we would answer through our audit work. The steps listed for each objective convey the type of work we would do. These may change as we learn more about the audit issues.

Objective 1: How does the KPERS 3 plan compare to other retirement plan options on key metrics like actuarial costs and replacement ratios? Our tentative methodology would include the following:

- Work with KPERS staff to identify important metrics for understanding and evaluating retirement plan options. This could include things like contribution rates, replacement ratios, and actuarial costs, including the normal cost of each plan design.

- Work with KPERS staff and other resources like the National Conference of State Legislatures and review recently proposed legislation to identify other retirement plan options to compare to. These could be options the Kansas Legislature has considered or that other states or the federal government use.

- Review state laws, retirement system guidelines, and other studies and analyses previously completed by KPERS to determine how KPERS 3 and the other retirement plan options compare on the key metrics identified above.

- Talk to KPERS staff and other states’ retirement staff as needed to understand significant differences in key metrics and the potential impacts they have on employers, employees, and the financial health of the retirement system.

- Interview or survey a selection of state and local agencies and school districts or current and former employees to get their opinions of the KPERS 3 plan. This could include whether it meets employees’ retirement needs, affected employees’ employment or retirement decisions, or impacted agencies’ ability to recruit and retain staff.

ESTIMATED RESOURCES

We estimate this audit would require a team of 3 auditors for a total of 4 months (from the time the audit starts to our best estimate of when it would be ready for the committee).