

PERFORMANCE AUDIT REPORT

Reviewing the Kansas Public Employees' Deferred Compensation Program

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
October 1996**

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$7 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

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October 21, 1996

To: Members, Legislative Post Audit Committee

Senator Lana Oleen, Chair
Senator Anthony Hensley
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Senator Don Steffes

Representative Jim Lowther, Vice Chair
Representative Tom Bradley
Representative Duane Goossen
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Representative Ed McKechnie

This report contains the findings, conclusions, and recommendations from our completed performance audit, *Reviewing the State Employees' Deferred Compensation Program*.

The report includes recommendations for improving the State's level of oversight of the Program, improving information provided to participants about the Program's fees, restrictions, and limitations, clarifying State law as to whether participants' moneys in the fixed-return accounts are covered by the Kansas Life and Health Insurance Guaranty Association, and incorporating new federal legislation into the State's Deferred Compensation Program.

We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton
Legislative Post Auditor



EXECUTIVE SUMMARY
LEGISLATIVE DIVISION OF POST AUDIT

**Question 1: Does the State Exercise Sufficient Oversight of The
Deferred Compensation Program To Ensure
That Its Employees Receive Good Quality Services
At a Reasonable Cost?**

The State exercises very little oversight of the Deferred Compensation Program. page 10
State law makes the Director of Personnel Services responsible for overseeing the Program. However, we found that the Division provides limited oversight, with essentially no monitoring of Aetna Investment Services in the areas of customer service, investment performance, and Program costs.

Had the State monitored services offered under the Program, it would have found that services offered by Kansas' Program are similar to those offered by nearby states. page 13
Those services included conducting employee informational seminars, processing fund allocation transfers, handling complaints, and the like. We also found that the 30 investment options offered by Kansas' Program compared favorably with the average number of investment options offered by the six nearby states' programs.

Had the State monitored the Program's investment performance, it would have found that performance to be comparable to the general market during fiscal year 1996. page 13
The rates of return earned by the fixed-return funds were comparable to other conservative, low-risk investments—such as government bonds—for the past fiscal year. The rates of return earned by the Program's variable-return funds also were comparable to those experienced by the market for that same time period.

Had the State monitored the Program's costs, it would have found Kansas' costs were comparable to program costs in other states we reviewed. page 16
The administration fees charged to Kansas employees with moneys in the Program's variable-return funds were lower than the fees of most other states we reviewed. In addition, management fees charged by funds in Kansas' Program compared favorably with similar fees for the other states' programs that provided comparable information. Finally, Kansas participants aren't charged a surrender fee for withdrawing their money when they quit the Program, like some participants in other states are charged.

Conclusion..... page 18

Recommendations..... page 19

**Question 2: How Satisfied Are State Employees With
The Services Provided Under
The Deferred Compensation Program?**

Participants generally were satisfied with the customer service aspects of the Program, although they need better information about moving their funds to other tax-deferred accounts. page 21
During this audit, we surveyed a total of 613 current Program participants. In all, 285 people responded (47%). The vast majority of respondents were happy with such things as how their complaints and questions were handled, the information they received about investment choices, and the ease of changing investment options. However, according to survey responses, there appears to be a misunderstanding about whether funds in the Program can be moved to other tax-deferred accounts after the employee quits the Program.

About two-thirds of participants were satisfied with the performance of their investments in the Program. page 22
Although respondents were less satisfied with this aspect of the Program than they were with customer services, this may reflect the performance of the individual investment options they selected. In such cases, the participant has the option of changing his or her investment options, or hoping for better future performance from his or her current chosen options.

About one-third of the participants responding to our survey agreed that Program fees are reasonable for the services provided. page 23
Participants were least satisfied with this aspect of the Program. Only 36% of survey respondents said they thought the fees charged for the Program were reasonable for the services provided.

Conclusion..... page 23

Recommendations..... page 24

**Question 3: What Liability Does the State Have
For Employees' Investments,
Should Aetna Default or Mismanage Funds?**

The State assumes no liability for losses incurred by Program participants in the event of insolvency or mismanagement of funds. page 25
According to Kansas law, the State isn't responsible for any loss incurred by an employee under the Program. However, we think State law is unclear as to whether participants' moneys in the Program's fixed-return accounts are covered by the Kansas Life and Health Insurance Guaranty Association if Aetna were to become insolvent.

Aetna operates in a highly regulated industry, and the controls now in place to monitor Aetna's overall operations should minimize the likelihood of insolvency or mismanagement. page 27
That monitoring includes reviews of Aetna's separate accounts, investment operations, and broker-dealer activities by such agencies as the Internal Revenue Service, the Securities and Exchange Commission, and the National Association of

Securities Dealers, Inc. Aetna's operations also are reviewed by several rating companies, which assess Aetna's ability to meet its long-term contractual obligations.

As a result of Aetna's internal precautionary measures, participants' money in the Program has some limited protection. page 29
Those measures include selecting investment managers from respected firms, carrying liability coverage on investment managers, and carrying corporate liability insurance for any fraudulent or dishonest acts committed by its officers or employees.

Recent changes in federal law also help protect participants' money from creditors in the event the State would ever become insolvent. page 29
Since the situation in Orange County, California, legislative changes have been made to prohibit access to moneys held in deferred compensation programs from the general creditors of the program sponsor. Beginning September 1996, federal law related to governmental deferred compensation plans required all moneys in such plans to be held in trust for the exclusive benefit of participants and their beneficiaries.

Conclusion..... page 30

Recommendations..... page 30

APPENDIX A: 457 Deferred Compensation Programs..... page 31
In Kansas and Six Nearby States

APPENDIX B: Comparison of Rates of Return..... page 35
Earned by Investments In the Kansas Public Employees' Deferred Compensation Program to the Rates of Return Earned by Comparable Standard Indices

APPENDIX C: 457 Deferred Compensation Programs in States..... page 37
With Aetna Investment Services

APPENDIX D: Summary of Survey Responses from Participants in..... page 41
the Kansas Public Employees' Deferred Compensation Program

APPENDIX E: Agency Responses..... page 45

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Reviewing the Kansas Public Employees' Deferred Compensation Program

The State offers its regular employees a deferred compensation plan that allows them to set aside a portion of their pre-tax earnings for retirement purposes. The State provides no match for the money these employees set aside.

The same deferred compensation plan is available to cabinet-level secretaries, members appointed to certain boards and commissions, any unclassified staff employee of officers of both houses of the Legislature, and any unclassified employee appointed to the Governor's or Lieutenant Governor's staff. These employees may elect to join the deferred compensation plan in lieu of membership in the Kansas Public Employees Retirement System, and the State contributes an amount equal to 8% of the employee's salary to the employee's deferred compensation account.

Aetna Investment Services, Inc. is the deferred compensation plan administrator, and has been since the start of the program in fiscal year 1981. Aetna was selected by a statutory Advisory Committee on Deferred Compensation established in 1976. One of the Committee's duties was to review companies applying to be plan administrator as part of a competitive-bid process. Aetna Investment Services currently offers 30 investment options, including guaranteed investment funds and mutual funds.

When the Legislative Post Audit Committee reviewed the Statewide Single Audit, members noted that the assets of the Deferred Compensation Fund exceeded \$175.4 million in fiscal year 1995. Committee members raised a number of questions about how those moneys were being administered, including:

- How was Aetna selected to be the trustee, and what oversight does the State exercise over Aetna?
- What rates of return are being earned for program participants?
- What management fees are being paid to Aetna, and who pays the fees?
- What liability does the State have for employees' investments, should Aetna default or mismanage them?

This audit answered the following questions:

1. **Does the State exercise sufficient oversight of the deferred compensation program to ensure that its employees receive good quality services at a reasonable cost?**
2. **How satisfied are State employees with the services provided under the deferred compensation program?**
3. **What liability does the State have for employees' investments, should Aetna default or mismanage them?**

To answer these questions, we interviewed officials from the Division of Accounts and Reports, Division of Personnel Services, and Aetna Investment Services,

contacted officials in the Department of Administration's legal department, the Kansas Insurance Guaranty Association, and the Attorney General's Office. In addition, we surveyed a sample of State employees who participated in the Kansas Public Employees' Deferred Compensation Program in fiscal year 1996. Finally, we contacted officials in six nearby states, as well as officials in those states where Aetna is an administrator or investment provider for the state's deferred compensation program.

In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office.

In general we found that the State exercises limited oversight of the Deferred Compensation Program, doing almost no monitoring of Aetna Investment Services in the areas of customer service, investment performance, and costs. This level of oversight is significantly less than that provided by other states we contacted. Had the State been monitoring Aetna during fiscal year 1996, it would have found adequate customer services, investment performance comparable to the general market, and costs comparable to other similar programs.

Based on our survey of a sample of Program participants, we concluded State employees generally were satisfied with the services provided under the Program. However, it appears that Program officials could do a better job of keeping participants informed about the limitations and requirements of the Program.

Finally, State law clearly indicates that the State isn't liable for any loss incurred by a participant in the State's Deferred Compensation Program. However, in our opinion, State law is unclear as to whether participants' moneys in fixed-return accounts are covered by the Kansas Life and Health Insurance Guaranty Association if Aetna were to become insolvent. Aetna operates in a highly regulated industry, and controls are in place to monitor its overall operations, which should minimize the likelihood of insolvency or mismanagement of funds. Recent changes in the federal laws regarding 457 deferred compensation plans will help to protect participants' money from creditors in the unlikely event the State becomes insolvent.

These and other findings will be discussed in greater detail following a brief overview of the Kansas Public Employees' Deferred Compensation Program.

Overview of the Kansas Public Employees' Deferred Compensation Program

Legislation passed by the 1976 Legislature enabled the State to offer its employees a deferred compensation plan under Section 457 of the Internal Revenue Service Code. Under this new plan, an eligible State employee could contribute a portion of his or her salary before taxes, invest that amount in some type of investment fund, and delay paying taxes on the amount contributed—plus the amount earned—until he or she quits the plan. Unlike some 401(k) retirement plans, the State doesn't match the employee's contribution. According to the law, this deferred compensation plan wasn't to be connected to or with any other retirement program, including the Kansas Public Employees' Retirement System.

Overall, State employees benefit three ways from a deferred compensation plan:

- *lower taxable income*—deductions for the Program are made before taxes are withheld from the employee's salary
- *delays in paying taxes*—taxes on the money in the Program are paid only at the time the employee quits the Program, and begins withdrawing money, probably at retirement when an individual's tax rate may be lower
- *portable retirement benefit*—an employee may be able to transfer benefits to a new employer, or leave them in the State's plan where they will continue to accumulate tax deferred. However, the money can't be transferred to another tax-deferred account like an IRA.

The profile on page four shows the difference between tax-deferred savings and after-tax savings.

The new legislation also provided for an Advisory Committee on Deferred Compensation. This Committee's role was to help the Director of Accounts and Reports set up the plan and select a firm or firms to provide investment options to State employees. The Director of the Budget, the Secretary of Administration, the State Commissioner of Insurance, and two employees appointed by the Governor—the Secretary of Revenue and Executive Secretary of the Kansas Public Employees' Retirement System—comprised the Committee.

On September 29, 1979, the Director of Accounts and Reports sent out requests for proposals to several dozen firms, requesting information from each firm about both administering the deferred compensation program, and serving as an investment provider. In all, 18 companies provided adequate information to be considered further.

With the help of Martin E. Segal, an investment consulting firm, the Advisory Committee narrowed the selection to four firms: Aetna, Lincoln, Mutual Benefit, and Security Benefit. After listening to presentations from all four firms, the Director of Accounts and Reports, with the approval of the Committee, signed a contract with Aetna Investment Services, Inc. to start offering a deferred compensation program to State employees on July 1, 1980.

What Does Tax-Deferred Mean in Dollars?

When a State employee begins to look at the advantages and disadvantages of joining the State's Deferred Compensation Program, one of the things that should be considered is the difference between a pre-tax and post-tax savings account. The table below shows the differences between the two types of savings programs after 10 years and after 20 years of savings, using the future value of an annuity.

	<u>Savings Account</u>	<u>Tax-Deferred Account</u>	<u>Difference</u>
Monthly Contribution	\$ 150	\$ 150	
Less income tax (a)	42	0	
Net monthly contribution	\$ 108	\$ 150	\$ 42
Net yearly contribution	\$ 1,296	\$ 1,800	\$ 504
If Moneys were Withdrawn In Full After 10 Years			
Total Contributions	\$ 12,960	\$ 18,000	\$ 5,040
Investment Earnings(b)	5,815	8,076	2,261
Less Income Tax(a)		7,301	
Income Tax on Earnings(a)	1,628		
TOTAL	\$ 17,146	\$ 18,775 (c)	\$ 1,628
If Moneys were Withdrawn In Full After 20 Years			
Total Contributions	\$ 25,920	\$ 36,000	\$ 10,080
Investment Earnings(b)	33,387	46,371	12,984
Less Income Tax (a)		23,064	
Income Tax on Earnings(a)	9,348		
TOTAL	\$ 49,959	\$ 59,307	\$ 9,348

(a) Tax rate used is 28% based on an average income of \$32,000 for Kansas participants in the State's Deferred Compensation Program in fiscal year 1996.

(b) A hypothetical interest rate of 8% was chosen for this example.

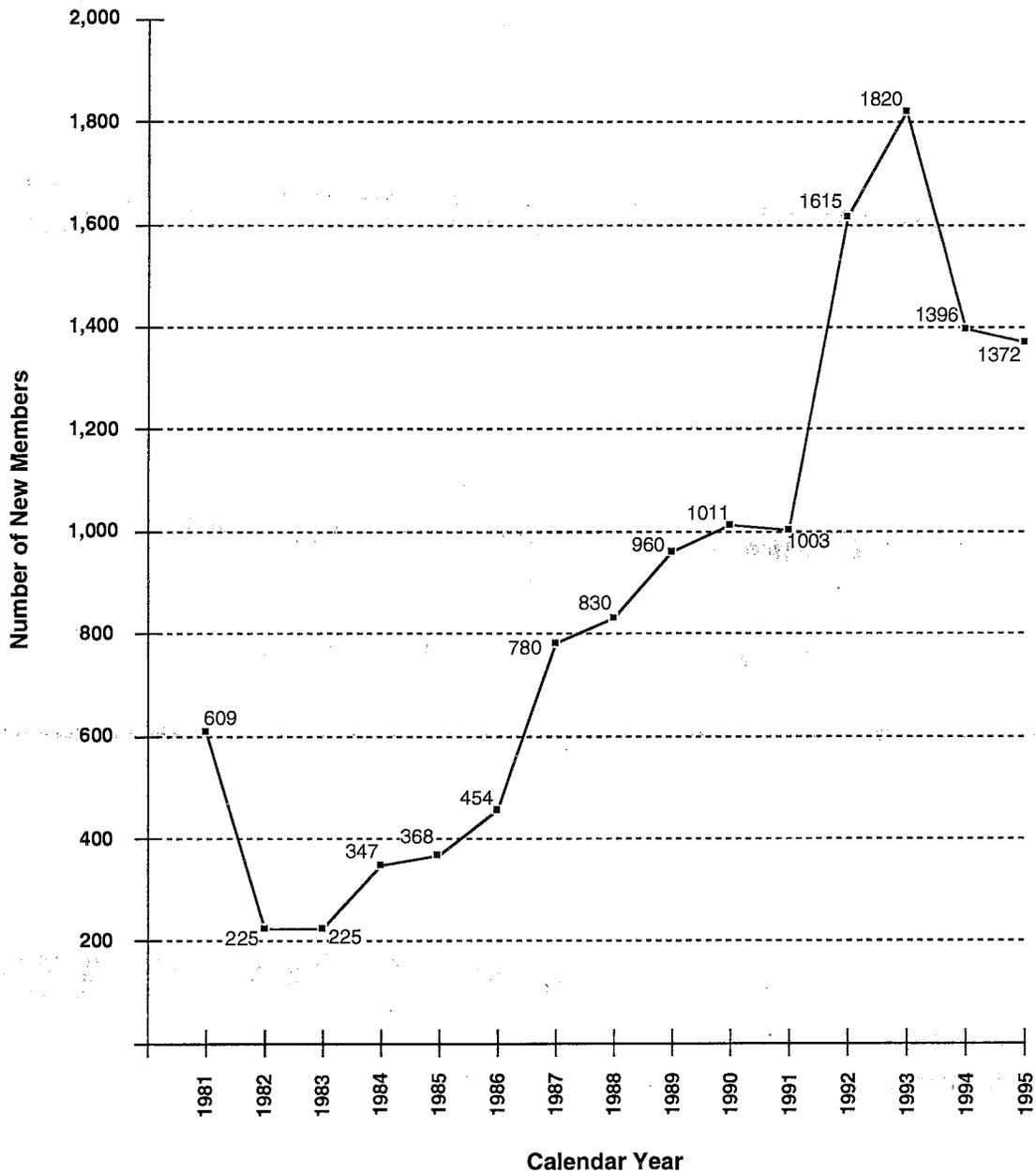
(c) If a surrender charge were applicable to the 10-year scenario, the difference would be somewhat less between pre-tax and after-tax.

The State's Deferred Compensation Program Has Grown Substantially

In 1980, more than 500 State employees enrolled in the Program. That number has grown to the almost 10,000 employees who actively contributed to the Program in fiscal year 1996. The graphic on the facing page shows how the number of new employees participating in the Program has grown since its inception.

In 1995, the average annual amount contributed to the Program was about \$2,100 per participant. Also in 1995, those receiving a benefit payment averaged an annual payment of more than \$4,400. The table on page six shows the average employee contribution to the Program from 1989 to 1996, and how the funds in the Program have grown over that same time period.

**Number of New State Employees Enrolling in the
State's Deferred Compensation Program
Calendar Years 1981-1995**



As shown in the graph, the number of new employees entering the Program during 1992 and 1993 reached an all-time high, then dropped back to a more normal "growth rate." State officials we talked with couldn't provide an explanation for the sudden increase and decrease.

**Profile of the State's Deferred Compensation Program
Calendar Years 1989-1996**

<u>Calendar Year</u>	<u>Number of Active Members</u>	<u>Average Annual Contribution</u> (per active member)	<u># of Members Receiving Benefit Payments</u>	<u>Average Annual Benefit Payment</u> (per retiree)	<u>Total Dollars in Program</u> (in millions)
1989	5,322	\$ 2,320			\$ 72.8
1990	6,008	2,360			87.6
1991	6,546	2,160			101.7
1992	7,412	2,250	952	\$ 4,045	117.9
1993	8,580	2,430	1,060	4,145	134.7
1994	9,226	2,280	1,203	4,314	150.3
1995	9,537	2,130	1,382	4,430	175.4
1996(a)	9,660	2,070	1,375	2,658	210.4

(a) Information shown is as of June 30, 1996. The average annual benefit payment for 1996 represents the average of benefit payments distributed during the first six months. Aetna officials told us that a large number of participants receive an annual benefit payment at the end of the calendar year.

The Internal Revenue Service and the State limit an employee's total annual Program contributions to a minimum of \$300, and a maximum of 25% of his or her gross salary or \$7,500, whichever is less. (The upper limit is scheduled to change with the new laws recently passed by Congress; however, that amount has yet to be determined by the Secretary of the Treasury.) Contributions are invested by Aetna Investment Services according to the investment choices selected by the employee. As shown in the table above, the Program's assets—employee contributions plus the amount earned on those contributions—have grown over the years from \$72.8 million in 1989, to more than \$210.4 million as of June 30, 1996.

The number of investment options offered to State employees by Aetna has grown from four to 30. The first year of the Program, employees could only select from one fixed rate-of-return fund and three variable rate-of-return funds. Over the years, the selections offered by Aetna have grown, as shown in the table below.

**Number of Investment Options Available to Employees in the
State's Deferred Compensation Program**

<u>Year</u>	<u>Number of Fixed Rate-of-Return Funds Added</u>	<u>Number of Variable Rate-of-Return Funds Added</u>	<u>Total Number of Investment Options</u>
1980	1	3	4
1983	2	0	6
1987	0	1	7
1989	0	1	8
1992	0	6	14
1994	1	1	16
1995	0	14	30
Total	4	26	30

As of June 30, 1996, about half of the moneys in the Program were invested in fixed rate-of-return funds (\$104.0 million), and half in variable rate-of-return funds (\$106.4 million). The tables on pages 14 and 15 of the report lists the various fixed and variable rate-of-return funds available to Program participants.

Fees to Cover the Program's Costs Are Collected in Different Ways

According to State law, the State isn't to incur significant costs for administering the Program. Those who participate pay for all associated costs related to the Program's administration, including the investment of their funds.

Employees investing in fixed-return accounts receive a guaranteed rate of return; Aetna keeps any amount it earns over the fixed rate. When the Program first started, participants investing in fixed funds paid a maintenance fee of \$15 per year. This amount was lowered to \$7.50 in 1987, and was discontinued in 1990. Under a fixed-return account, Aetna guarantees the participant a rate of return on his or her money. Aetna invests participants' money in whatever types of investments it chooses, typically corporate and Treasury bonds and mortgage-backed securities. Any investment earnings that exceed that guaranteed rate are kept by Aetna as its payment for administering the Program and investing the money. If the investment earnings are less than the guaranteed rate, Aetna must make up the difference.

Employees investing in variable-return accounts pay fees both to Aetna and to investment managers; those fees are deducted before any earnings are distributed to participants. Originally, Program participants investing in variable-return funds also paid Aetna a maintenance fee (which has since been discontinued), an administration fee, and an investment management fee. Such fees are deducted from the investment earnings on the participants' accounts before any of the earnings are distributed, which effectively lowers participants' rate of return. The various fees currently charged by the Program are described below:

- *administration fee charged by Aetna*—Administration fees are based on the amount of money (assets managed) an employee has invested in the Program's variable-return accounts. In 1980, the administration fee was 1.25% of the assets managed. It was lowered to 0.95% in January 1996. Although the amount collected for administration fees isn't published, Aetna officials estimated that Kansas participants paid about \$1 million in such fees in fiscal year 1996.
- *investment management fee*—This fee also is based on the amount of assets managed; however, it varies from fund to fund. The fee includes all expenses associated with the fund, including advisory fees and operating expenses. In fiscal year 1996, the investment management fees for Kansas participants averaged about 0.51% of assets managed, ranging from .31% to 1.47%. We estimated that Kansas participants paid more than \$540,000 in management fees that year on funds that were valued at more than \$106 million. Like administration fees, investment management fees are deducted before earnings are distributed to participants, further lowering the participants' rate of return.

**For a Select Group of Employees, the State Contributes to the
Deferred Compensation Program on Their Behalf**

Under K.S.A. 74-4911f, the following State employees may elect to join either the Kansas Public Employees' Retirement System (KPERs) or the State's Deferred Compensation Plan:

- cabinet-level secretaries
- Superintendent, Kansas Highway Patrol
- State Grain Inspector
- Executive Director, Kansas Racing Commission
- President, Kansas Development Finance Authority
- State Fire Marshal
- State Librarian
- Securities Commissioner
- Adjutant General
- members of the State Board of Tax Appeals
- members of the Kansas Parole Board
- members of the Kansas Corporation Commission
- any unclassified employee on the staff of officers of both houses of the Legislature
- any unclassified employee appointed to the Governor's or Lieutenant Governor's staff

Legislative changes made during the 1996 session limit legislative session-only employees to the Deferred Compensation Program.

Officials at the Legislative Research Department told us this option was made available to selected State employees as a sort of "portable retirement system," and to help subsidize their salaries. The Joint Committee on Pensions, Investments, and Benefits is studying the feasibility of adding all legislators to this group.

Two major differences between the Deferred Compensation Program and KPERs are the amount the employee contributes, and the amount the employee receives when he or she quits State employment. The table below shows the difference in the amount of money contributed by an employee under both KPERs and Deferred Compensation, and what an employee will be able to take with him or her when leaving State employment after four years of service. The calculations are based on an annual salary of \$30,000.

	<u>KPERs</u>	<u>Deferred Compensation</u>
Annual Amount Contributed To Employee's Account		
By Employee (4% of salary)	\$ 1,200 (a)	\$ 0
By State on behalf of Employee (8%)	0	2,400
 Total amount employee could take with him or her if that employee quit after four years (b)	 \$ 3,600	 \$ 9,600

(a) The State also contributes to the Retirement System, based on a percentage of all employees' salaries. However, an employee can't take that money with him or her when leaving State employment. In addition, the employee makes no contributions the first year of employment.

(b) Employees also can take the interest or investment earnings credited to their accounts. For current KPERs members, their accounts earn 4% interest. Employees in the Deferred Compensation Program may earn variable rates of interest on their investments.

**Participants Can Receive Benefit Payments
From the Deferred Compensation Plan
When They Quit the Program**

A participant can quit the Deferred Compensation Program either by retiring or terminating his or her employment with the State. Participants who quit the Program can elect to receive benefits from five different payment plans:

- receive a lump-sum payment
- start receiving regular periodic benefit payments

- defer payment of benefits until some future date
- choose some combination of the three choices listed above
- transfer his or her money in the Plan to a new employer (if eligible)

Aetna representatives consult with those leaving the Program about the various options available, and help them determine which option would best fit their individual needs.

Once a participant quits the Program, he or she has 180 days to decide about the choice of benefit payment. If a specific selection isn't made in that time period, then by law the participant will receive the money in his or her account in 120 equal payments (a benefit payment once a month for 10 years). If a participant dies before quitting the Program, his or her spouse, if the beneficiary, can select from the same five options. However, a non-spouse beneficiary is limited to a payout period of no more than 15 years.

Does the State Exercise Sufficient Oversight Of the Deferred Compensation Program to Ensure That Its Employees Receive Good Quality Services at a Reasonable Cost?

The State exercises very limited oversight of the Deferred Compensation Program, doing almost no monitoring of Aetna Investment Services in the areas of customer service, investment performance, and costs. This level of oversight is significantly less than that provided by other states we contacted. One possible reason for this situation is that, when the Legislature transferred the Program's oversight responsibility from the original Advisory Committee to the Division of Personnel Services, it didn't specify the oversight activities to be performed. Had the State been monitoring Aetna during fiscal year 1996, the period we reviewed for this audit, it would have found adequate customer services, investment performance comparable to the general market, and costs comparable to other similar programs. These and other findings are discussed in greater detail in the sections that follow.

The State Exercises Very Little Oversight of The Deferred Compensation Program

Good management practices suggest that sufficient oversight of the State's Deferred Compensation Program would focus on customer service, investment performance, and costs, and would include such things as:

- finding out how the program is operating in such areas as customer service, investment performance, and costs
- evaluating Program operations in light of legal and contractual requirements, comparability with other deferred compensation programs, and customer expectations and satisfaction. These would include:
 - reviewing participants' access to a number of investment options with varied risk levels
 - periodically comparing the rates of return earned on the various investment options to standard investment performance indices
 - reviewing administration and investment management (fund) fees for reasonableness
- reviewing audits conducted on the program and other reports to ensure its operations are following all applicable rules and regulations
- reporting findings to State decision-makers, including the Legislature

We found that the State does none of the things outlined above. Although State law prohibits the State from incurring any "significant" costs in administering the Deferred Compensation Program, the law currently doesn't preclude the State from providing some base level of oversight to ensure that the benefit being provided to State employees is still accomplishing the goals and purposes intended.

State law makes the Director of Personnel Services responsible for oversight of the State's Deferred Compensation Program; however, those duties are no longer spelled out in law. As described in the Overview, when the Program was established, State law created an Advisory Committee on Deferred Compensation and charged that Committee with several oversight responsibilities. Those responsibilities were:

- *advise and consult*—with the Director of Accounts and Reports in the implementation and administration of Program
- *review and analyze*—the Program's operation, and make recommendations to the Director of Accounts and Reports and the Legislature for improvements
- *assist in the preparation of the rules and regulations*—for the administration of the Program
- *approve or disapprove insurers or other contractors*—for participation in the Program
- *recommend consultants*—to assist the Director of Accounts and Reports in the administration of the Program

The previous Director of Accounts and Reports told us the Advisory Committee and its staff were very active in the oversight of the State's Deferred Compensation Program, including reviewing literature about deferred compensation plans, the Program's investment performance and costs, and other states' experiences. He said the Committee also was active in reviewing financial hardship requests by participants wanting to withdraw their money from the Program. Finally, he told us that, as Director and staff member of the Committee, he was active in the National Association of Government Deferred Compensation Administrators, an association that provides information about government deferred compensation programs.

The law that established the Advisory Committee also included language regarding that Committees' duties and responsibilities related to oversight of the Program. On July 1, 1988, the law establishing the Advisory Committee was repealed, and all duties and powers of the Committee were transferred to the Director of Personnel Services or the Director's designees. However, the statutes giving the Director this responsibility no longer lists those duties and responsibilities for oversight of the Program.

The previous Director of Accounts and Reports told us he continued to oversee the Program after the Committee was abolished, and until he left State employment in January 1995. However, he said, the Division of Personnel Services handled the financial hardship withdrawal requests.

The Division of Personnel Services performs very limited oversight of the Program, and seems to view oversight as unnecessary. Officials at the Division of Personnel Services told us their involvement with the Program essentially was limited to the following:

- reviewing financial hardship requests from participants who wish to withdraw their money before they quit the Program
- scheduling Program informational seminars for the Department and pre-retirement seminars for the State
- monitoring informational presentations about the Program conducted by Aetna, including occasionally attending seminars conducted in Topeka

Officials at the Division of Personnel Services stated that they knew their statutory responsibilities were broader, but that they hadn't done more because the previous Director of Accounts and Reports continued to administer the Program until January 1995. They also told us their involvement in the Deferred Compensation Program didn't change when the new Director of Accounts and Reports arrived in June

1995, even though that Division no longer provided any oversight of the Program. (According to the current Director of Accounts and Reports, her Division is involved only in the mechanics of the Program—processing contributions to the Program authorized by employees.) Finally, the Director of Personnel Services told us the State receives very few complaints about the Program.

We wanted to review a sample of the complaints received, but found that those complaints were kept informally in files with the Director or Aetna. We also found that the Division of Personnel Services didn't have any written policies and procedures for handling complaints. Without some written guidance, there's a risk participants won't know who to contact when they have a complaint, complaints won't be handled in a consistent manner, and information about a problem won't be shared between the State and Aetna.

The Department of Administration's legal staff has concluded the State doesn't appear to have a duty to provide oversight of the Program. The staff reported that the Deferred Compensation Plan, participation agreements signed by participants, and other related documents don't appear to impose such a duty on the State.

The contract between Aetna and the State doesn't outline any oversight requirements regarding the Deferred Compensation Program. The State's contractual obligations are more related to providing information about participants and payroll deductions to Aetna. The contract does list some specifics for Aetna—including using licensed personnel, insuring the timely and proper investment and allocation of all payments, and issuing benefit payments.

Even though the State doesn't provide oversight of the Program, we found this isn't the practice in nearby states. To help determine if there are any national standards or guidelines regarding oversight of a 457 deferred compensation plan, we contacted the National Association of Government Deferred Compensation Administrators. An official from that organization said there were no national standards or guidelines.

We then contacted officials in nearby states to gather information about their programs and to see how their administration and oversight compared to Kansas' Program. The states we contacted were Arkansas, Colorado, Iowa, Missouri, Nebraska, and Oklahoma.

Of the six states, all but Iowa use a third-party administrator for their deferred compensation programs. A third-party administrator, like Aetna, takes care of the administration aspects of the Program, including informational seminars, periodic reports, and investment of funds. Iowa administers its deferred compensation program internally.

Oversight measures reported by nearby states include the following:

- *periodic reports to an oversight group*—Colorado, Missouri, and Nebraska have the third-party administrator report to a legislative committee or an oversight board

- *periodic review of the program*—Arkansas, Colorado, and Oklahoma review the program on a monthly basis, with the help of a consultant, regarding such issues as investment performance, fees, and the like, Iowa and Nebraska conduct an annual audit of the plan, and Missouri reviews its plan quarterly.
- *periodic written reports*—Colorado, Missouri, and Nebraska require the third-party administrator to provide reports showing investment performance, fund activity, and the like
- *periodic opening of the contract to bids*—Missouri and Oklahoma reported opening the contract for bids every four to five years. Nebraska opened its contract for bids this year for the first time since starting the program in 1976.

Had the State Monitored Services Offered Under the Program, It Would Have Found that Services Offered by Kansas' Program Are Similar to Those Offered by Nearby States

We asked officials in the nearby states about the services offered by their deferred compensation programs, including the services provided by the third-party administrator, number of investment providers, and investment options available to participants. Appendix A shows the information we collected.

We found that the services offered by states with third-party administrator are similar to those offered to Kansas participants by Aetna, including the following:

- conducting employee informational seminars and training agency personnel staff
- processing transactions of fund allocations
- handling complaints and problems related to the deferred compensation program
- providing participants quarterly or annual statements about their account activity and account balances
- disbursing benefit payments

We also looked at the number of investment options available to participants in the deferred compensation programs. On average, the other states' programs offer 30 different investment options, ranging from 13 in Colorado to about 60 in Iowa. That compares favorably with Aetna, which currently offers Kansas participants 30 different investment options as well.

Had the State Monitored the Program's Investment Performance, It Would Have Found That Performance To Be Comparable To the General Performance of the Market During Fiscal Year 1996

The fixed-return funds available to participants under the State's Deferred Compensation Program are similar in some respects to long-term certificates of deposit in a financial institution, with the additional benefit of being tax-deferred. The variable-return funds are more similar to mutual funds.

For fiscal year 1996, rates of return on the Program's fixed-return funds were comparable to other conservative, low-risk investments such as govern-

ment bonds. The table below shows rates of return for the Program's fixed-return funds. Those rates of return are higher than many of the similar, alternative investment options available in the private sector, such as government and corporate bonds. Standard indices for these types of investments reported rates of return ranging from 4.51% to 5.60%, as of June 30, 1996. In addition, we looked at the rates of return for fixed-return funds of four other deferred compensation investment providers. Those rates ranged from 4.30% to 6%.

**Investment Performance for Fixed-Return Funds in the
State's Deferred Compensation Program
June 30, 1996**

<u>Investment Fund</u>	<u>Fund Value</u> (in millions)	<u>Rate of Return</u>
Aetna Fixed Account	\$ 70.1	6.13%
Aetna Fixed Plus Account	33.1	6.33%
Aetna Guaranteed Accumulation Long-term (a)	.2	5% to 5.25%
Aetna Guaranteed Accumulation Short-term (a)	.7	4% to 4.5%

(a) The rates of return for Aetna Guaranteed Accumulation Long-term and Short-term Funds aren't annualized. Therefore, we could only show the ranges of returns from July 1, 1995, to June 30, 1996.

For fiscal year 1996, rates of return on the Program's variable-return funds were comparable to those experienced by the market. The third column in the table on the facing page shows rates of return reported by the Program's variable-return investment options for the past fiscal year. However, those rates of return are reported "net of fees," or after administrative and investment management fees have been taken out.

To determine how the Program's investments have performed compared to the market, those fees have to be added back in because the standard indices have no fees. We have done that in the sixth column in the table. Although the actual calcu-

Mutual Funds: Open-Market Versus Tax-Deferred

In 1992, Aetna began offering State employees access to mutual funds similar to those available to the general public, with management firms like Neuberger and Berman, Scudder, and Twentieth Century. Since then, questions have been raised about why the rates of return for the funds in the State's Deferred Compensation Program weren't the same as those reported by the open-market funds in national magazines and newspapers.

In 1982, the federal government ruled that mutual funds available on the open market couldn't be used in a tax-deferred program. In response to this requirement, mutual funds created "sister funds" that mirrored their open market funds. These sister funds are available only to participants in tax-deferred programs.

Aetna officials told us the mutual funds in a tax-deferred program are both similar to and

different from their sister funds in the open market. Both funds have the same investment managers and similar risk levels. However, they're comprised of different stocks, have different buy/sell activity, and require different cash balances.

Aetna officials told us that participants in tax-deferred programs generally are in for the longer-term. This longer-term investing allows the funds' investment managers to invest more of the money, rather than holding it in cash reserves to settle the accounts of those investors who leave the fund every time the market takes a downturn. They told us that over time, this difference should allow tax-deferred funds to out-perform those funds available in the open-market. Officials with the National Association of Government Deferred Compensation Administrators concurred with these statements.

Calculations required aren't as simple as those shown in the table, this rough approximation will make comparisons of the Program's funds' performances to the appropriate standard indices much simpler. The standard indices' rates of return shown in the table are those Aetna uses to determine the funds' performances to the markets.

**Investment Performance for Variable-Return Funds in the
State's Deferred Compensation Program
Compared To Standard Indices
June 30, 1996**

<u>Investment Fund</u>	<u>Fund's Value</u> (in 000's)	<u>Fund's Rate of Return</u> (after fees)	<u>Invest. Mgrs. Fee</u>	<u>Aetna's Admin. Fee</u>	<u>Approx. Rate of Return</u> (before fees)	<u>Index's Rate of Return</u>
STOCK FUNDS						
Aetna Ascent Variable	\$ 30.4	19.41%(a)	.65%	.95%	21.01%	16.23%
Aetna GET Fund	5,504.0	22.35	1.00	.95	24.30	17.30
Aetna Legacy Variable	124.1	13.30(a)	.65	.95	14.90	10.22
Aetna Variable Fund	60,086.8	25.07	.31	.95	26.33	26.12
Alger American Growth	905.4	14.92	.85	.95	16.72	26.12
Alger American Small Cap	5,751.4	16.83	.92	.95	18.70	26.49
Fidelity VIP Equity-Income	586.8	20.93	.61	.95	22.49	26.12
Fidelity VIP Growth	614.3	19.96	.70	.95	21.61	26.12
Fidelity VIP II Contrafund	530.1	19.79	.72	.95	21.46	26.12
Janus Aspen Aggressive Growth	2,198.6	32.59	.86	.95	34.40	21.59
Janus Aspen Growth	209.4	25.42	.78	.95	27.15	26.12
Lexington Natural Resources Trust	294.7	18.74	1.47	.95	21.16	26.12
Neuberger & Berman Growth	2,356.2	13.30	.94	.95	15.19	26.12
TCI Growth	7,034.8	10.08	1.00	.95	12.03	27.67
BALANCED FUNDS						
Aetna Crossroads Variable	\$ 276.8	16.32%(a)	.65%	.95%	17.92%	13.20%
Aetna Investment Advisors	8,394.5	17.22	.33	.95	18.50	17.30
Calvert Responsibly Invested Balanced	576.3	12.96	.83	.95	14.74	15.03
Janus Aspen Balanced	51.4	17.73	1.37	.95	20.05	23.89
BOND FUNDS						
Aetna Income Shares	\$ 3,476.3	4.42%	.33%	.95%	5.70%	5.02%
Franklin Government Securities Trust	496.3	3.67	.76	.95	5.38	5.47
Janus Aspen Flexible Income	86.1	10.21	1.07	.95	12.23	4.66
Janus Aspen Short-Term Bond	8.7	3.30	.70	.95	4.95	5.47
INTERNATIONAL FUNDS						
Fidelity VIP Overseas	\$ 60.0	12.09%	.91%	.95%	13.95%	13.62%
Janus Aspen Worldwide Growth	1,011.3	39.22	.90	.95	41.07	19.00
Scudder VLIF International	3,720.2	15.33	1.08	.95	17.36	13.62
MONEY MARKET FUNDS						
Aetna Variable Encore Fund	\$ 2,031.6	4.59%	.35%	.95%	5.89%	5.04%

(a) The rate of return shown is for less than one year (7-3-95 through 6-30-96).

How Well is Aetna Informing Program Participants About Fees?

To determine how well Aetna informs State employees about the Program and its expenses, we attended an informational seminar conducted for Department of Administration employees. During the presentation, the representative stated there were no maintenance fees associated with the Program; therefore, he said 100% of the money employees put in the Program went to work for them. While it's true there are no maintenance fees, the representative didn't mention that, on variable-return funds, administration and investment management fees are taken out of the earnings on an employee's contributions before those earnings are credited to the employee's account. This may contribute to employees lack of awareness of Program fees.

As shown by the bold-faced numbers in the table, slightly more than half the funds (14 of the 26 funds listed) performed as well as or better than the comparable market index during fiscal year 1996, when fees are considered. (Even with fees taken out, eight funds performed better than the comparable standard index.)

A review of longer-term rates of return showed similar results. Because investing is a long-term process, we also looked at those options for which Aetna could report longer-term rates of return. The rate of return for the funds that reported three-year, five-year,

and 10-year averages generally were comparable to averages of the market indicators for the same time period, when fees are considered. Appendix B shows rates of return for these three periods, ending June 30, 1996.

Aetna officials report that investment managers' performance and investment options are reviewed periodically. We asked officials at Aetna what they do to ensure that investment managers perform at an acceptable level. They told us Aetna uses performance measures for each fund compared to the fund's appropriate index. In addition, a third-party calculates the rates of return to ensure accuracy and independence.

Finally, investment managers for the variable funds report to Aetna's Mutual Fund Board, while the Board of Directors reviews the fixed investments. Both Boards include non-Aetna representatives, and meet quarterly. These meetings are attended by the investment managers of the Aetna Funds and the head of Aetna investments.

Had the State Monitored the Program's Costs, It Would Have Found Kansas' Costs Were Comparable To Program Costs in Other States We Reviewed

Costs associated with a deferred compensation program can include a variety of fees, including maintenance fees, administration fees, investment management fees, and surrender fees. The costs for each Program participant will vary, depending on what investment options he or she selects, the services provided by the administrator, the number of participants in the Program, and the amount of money invested in the Program. As noted earlier, Kansas participants no longer pay a maintenance fee. However, participants in the variable-return funds do pay both an administration fee and an investment management fee.

Administration fees charged to Kansas employees with moneys in the Program's variable-return funds were lower than the fees of most other states we reviewed. Of the five nearby states that use a third-party administrator, only two states—Arkansas and Nebraska—were charged an administration fee based on the

amount of money in the fund. For comparison purposes, we also looked at the two other states—Mississippi and Vermont—that use Aetna as their third-party administrator for the deferred compensation program. The table below shows how Kansas' administrative costs compared with those of other states we reviewed.

**Administration Fees Charged as a Percent of Assets Managed
Kansas and Four Other States
Fiscal Year 1996**

<u>State</u>	<u>Total \$ in Program</u> (in millions)	<u>Adm. Fees Charged</u>	<u># Investment Providers</u>
Mississippi	\$ 275	1.25%	9
Arkansas	111	1% to 1.25%	2
Vermont	65	1.15%	8
Kansas	210	0.95%	1
Nebraska	70	0.825% plus \$20 a year	1

As the table shows, Kansas' administration fees are among the lowest charged, even when compared with other states that use Aetna. The table also shows that the states with the lowest fees have only one investment provider, which also provides the administrative services for the program. As the number of providers increases, so do the options available and the amount of administration work required. Appendix C provides information for states where Aetna is an investment provider or third-party administrator.

In general, management fees charged by funds in Kansas' Deferred Compensation Program compare favorably with similar fees for the small sample of other states' programs we received comparable information. Investment management fees depend on a variety of things, including the type of fund, the amount of money invested in the fund, the amount of research needed to manage the fund, and the like. Because Aetna is one of the larger insurance companies operating in the investment industry, it has a large dollar amount to offer investment managers.

We compared the management fees charged by funds in Kansas' Deferred Compensation Program with fees charged by funds in the nearby states' programs that provided such information: Missouri, Nebraska, and Oklahoma. The table below shows the management fees we were able to compare.

**Investment Management Fees Charged as a Percent of Assets Managed
Kansas and Three Other States
Fiscal Year 1996**

<u>State</u>	<u>Total Program Dollars</u> (in millions)	<u>Range of Investment Management Fees Charged</u>				
		<u>Stock Funds</u>	<u>Bond Funds</u>	<u>Balanced Funds</u>	<u>Internat'l Funds</u>	<u>Money Mkt. Funds</u>
Kansas	\$ 210	0.31-1.47%	0.33-1.07%	0.33-1.37%	0.90-1.08%	0.35%
Missouri	439	0.48-1.33%	0.44-1.09%	0.58-1.06%	1.06%	0.65%
Nebraska	70	0.50-0.83%	0.48-0.55%	0.66-0.80%	0.85%	0.47-0.58%
Oklahoma	160	0.79-1.25%	0.76-0.80%	0.95%	na	0.73%

As the table on the previous page shows, investment management fees for variable-return funds in Kansas' Deferred Compensation Program compare favorably on the low end of the ranges shown. However, Kansas' investment management fees at the high end of the ranges shown are among the highest charged. During this audit, we couldn't do an in-depth study to try to explain why such differences exist.

Kansas participants aren't charged a surrender fee like some participants in other states are charged. A surrender fee is an amount charged to take money out of an investment provider's deferred compensation plan or move the money to another investment provider. Kansas participants were charged a surrender fee for withdrawing moneys until 1990. Now, because Aetna is the State's only provider, the fee no longer applies to Kansas participants.

In those states where surrender fees are applicable, participants are charged a certain percent of the amount being removed from the investment provider's plan. Generally, that percentage is determined by the number of years the money was invested with the provider, and decreases as the number of years increases.

Conclusion

Kansas hasn't had significant oversight of its Deferred Compensation Program for the past one-and-one-half years, even though this increases the risk that the Program isn't meeting the State's goal of providing a good benefit to employees. We found that the State's Deferred Compensation Program, administered by Aetna, compares favorably in most aspects. Although we think oversight is important, and that the State should consider re-evaluating its contractual relationship more frequently than once every 15 years, State employees haven't been harmed.

Companies involved in providing investment options for 457 deferred compensation plans appear to be competitive in the number and types of investment options offered. However, the question is whether the State wants to depend solely on market forces to ensure the quality and costs of its Deferred Compensation Program offered to employees.

We think that, with a minimal amount of effort, the Division of Personnel Services could provide the type and level of oversight that would give State officials greater assurance that the Program compares favorably with other such programs, and is meeting the needs and interests of State employees. Types of information State officials receive from these oversight efforts could guide decisions on whether or when to re-bid the contract, or request other changes or information that would benefit State employees.

Recommendations

1. To ensure that the Kansas Public Employees' Deferred Compensation Program is providing good quality services at a reasonable cost, the Division of Personnel Services should develop basic written policies and procedures regarding the oversight of the Deferred Compensation Program. Those policies and procedures should incorporate the duties and responsibilities required by law and good management practices, including:
 - a. finding out how the program is operating in such areas as customer service, investment performance, and costs
 - b. evaluating those operations in light of legal and contractual requirements, comparability to other deferred compensation programs, and customer expectations and satisfaction including:
 - reviewing participants access to numerous investment options that are varied across different risk levels
 - periodically comparing the rates of return earned on the various investment options to appropriate standard investment performance indices
 - reviewing administration and investment management (fund) fees for reasonableness
 - c. developing a procedure for handling complaints about the Program, and sharing complaint information with all those involved in the operations of the Program
 - d. reviewing audits conducted on the Program or third-party administrator and other reports to ensure its operations are following all applicable rules and regulations
 - e. reporting findings on a periodic basis to State decision-makers, including the Legislature
2. To ensure that the oversight and administration responsibilities of the Divisions of Personnel Services and Accounts and Reports are clearly defined, the Legislative Post Audit Committee should consider adding specific language about those responsibilities to K.S.A. 75-5523.

How Satisfied Are State Employees with the Services Provided Under the Deferred Compensation Program?

Based on our survey of a sample of Program participants, we concluded State employees generally were satisfied with the services provided under the State's Deferred Compensation Program. However, we found that they need better information about moving their funds to other tax-deferred accounts when they quit the Program. Participants are quite satisfied with the customer-service aspects of the Program. Although few employees complain, most are satisfied with the resolution of their complaints. Participants were less satisfied with the Program's investment performance; 68% reported they were satisfied with the performance of their investments this past fiscal year.

Participants were least satisfied with the Program's costs—administrative and investment management fees. In fact, only 36% of respondents to our survey thought the Program costs were reasonable for the services provided, and less than half were satisfied with the information they got on fees charged. Finally, it appears that Program officials could do a better job of keeping participants informed about the limitations and requirements of the Program. These and other findings are discussed in more detail in the sections that follow.

We Surveyed a Sample of Program Participants To Find Out Their Level of Satisfaction With the Program

To find out what Kansas participants thought of the State's Deferred Compensation Program, we surveyed a sample of 613 of the more than 13,600 State employees who were enrolled in the Program during fiscal year 1996. Overall, 285 responded, for a response rate of 47%. We surveyed the following groups of participants:

- *active participants*—those employees who were making contributions to the program during fiscal year 1996. We surveyed 370 of the 9,660 active members, and received surveys from 166 (45%).
- *inactive participants*—those employees who were enrolled in the Program, but weren't making contributions during fiscal year 1996. We surveyed a total of 122 of the 2,623 inactive participants, and received 51 surveys back (42%).
- *participants receiving benefit payments*—those employees who had quit the Program and received a benefit payment during fiscal year 1996. We mailed 121 surveys to the 1,375 employees receiving a benefit payment, and had 68 returned (56%).

We asked participants a variety of questions about the Program, including questions about the handling of complaints, information provided about the Program, investment performance, administration and investment management fees, and general knowledge of the Program. The survey results regarding each of these areas is discussed in detail in the sections that follow. Appendix D shows the responses from the surveys of Program participants.

**Participants Generally Were Satisfied With
The Customer Service Aspects of the Program, Although
They Need Better Information About Moving Their Funds
To Other Tax-Deferred Accounts**

Customer-service aspects of the Deferred Compensation Program include such things as the frequency of mistakes and complaints; how complaints and questions are handled, information provided to participants about choices, and ease of changing investment choices. Participants generally were satisfied with these aspects of the Program, as discussed below:

- *Participants reported finding few mistakes.* Only 1.4% of those responding pointed out that mistakes had been made, either by the State in withholding moneys, or by Aetna in its quarterly reports. In almost every case, the respondent indicated the mistake had been corrected in a timely manner.
- *Participants reported making few complaints to either Aetna or the State.* Only 13 of the 285 respondents (4.6%) indicated they had made a complaint. About half those complaints were reported to Aetna. Four people weren't satisfied with how their complaints were resolved, but two of those complaints were related to things that couldn't be resolved, such as participants not being able to move Program moneys into another tax-deferred account.
- *Most participants who raised a question with Aetna officials were satisfied with the answers they received and the manner in which they were treated.* In all, 78% of our respondents had asked Aetna officials a question about the Program. Of those, 98% were satisfied with the answers they got, and 99.5% were satisfied with the way they were treated by Program officials.
- *Most participants were satisfied with the information provided by Program officials regarding choices they could make.* We asked about information participants got to help them decide whether to join the Program, what investment options were available, and what withdrawal options were available upon retirement. More than 90% of those responding indicated satisfaction with information about joining the Program and investment options. In all, 26% were dissatisfied with information about withdrawal options, or didn't know if they received enough information. However, that dissatisfaction was concentrated in the two groups that hadn't yet received the intensive guidance provided to those actually faced with that situation. Of the respondents who were retired, 87% were satisfied with the information they received from the Program about withdrawal options.
- *Most participants were satisfied with the Program's ease of changing the investment options selected.* Of those responding, 79% indicated their satisfaction with this aspect of the Program; only 2% indicated dissatisfaction. The rest either didn't know or had no opinion.

According to survey responses, there appears to be a misunderstanding about whether funds in the Program can be moved to other tax-deferred accounts after the employee quits the Program. According to Section 457 of the Internal Revenue Service's Code, money invested in a 457 deferred compensation plan

Participants Speak Out About the State's Deferred Compensation Program

On July 30, 1996, we mailed surveys to a sample of 613 participants of the State's Deferred Compensation Program. In all, 285 participants sent back their surveys, for a response rate of 47%. Some of the surveys included comments about the Program. About 51% of the comments were negative, 26% were positive, and the rest were either neutral comments about the Program or complaints about IRS restrictions.

Those responding with positive comments about the Program were similar to the examples shown below:

- "I only wish it had been possible for me to have enrolled at an earlier time in my employment and that I would have made a larger investment each month."
- "I am very pleased with the Program. It has earned more money than any other investment I have made."
- "I'm sure glad I joined this Program during my working years. Now I am enjoying my checks each month."

However, not all comments were positive. The follow are examples of those comments made about problems with the State's Deferred Compensation Program:

- "There is lack of communication, especially after retiring and selecting a payback option."
- "Need additional information on derivatives, investment manager fees, investment options, withdrawal options at retirement, comparison of Aetna versus other companies offering deferred compensation plans, and need annual meetings at district offices."
- "The new fees charged were not agreed upon when I started nor was I advised of an upcoming change. Just more dirty tricks to get my money."

Overall, participants seemed pleased with the Program, with Aetna representatives, and with the performance of their investments. But, as these comments show, it appears that participants aren't happy with all aspects the Program.

can't be moved to another tax-deferred account, such as an IRA (individual retirement account) or 401(k). This fact is clearly stated on the contract the employee signs when joining the Program.

However, about 70% of participants answering our survey reported they thought they could move their money to another tax-deferred account when they quit the Program. This misunderstanding could cause two serious problems for participants if they were to make such a move. One, once the money is withdrawn, the participant will be forced to pay taxes on that money (principal plus interest). Two, this action could result in penalties by the Internal Revenue Service in addition to the taxes due on the money. Because so many participants misunderstood this point, and the consequences are so grave, we think this is an area where participants in the Program need additional information and periodic reminders.

About Two-Thirds of Participants Were Satisfied With the Performance of Their Investments in the Program

To find out about participants' satisfaction with the performance of their investments, we asked about investment results and the related information provided by Aetna. The results are summarized below:

- 80% of those responding were satisfied with the information they got about their investments' performance.
- 68% of those responding to our survey were satisfied with their investments' performance; 11% were dissatisfied.

As these figures show, participants were less satisfied with the Program's investment performance than with its customer service. However, some of this may result from the performance of the individual investment options they selected. In such cases, the participant has the option of changing his or her investment options, or hoping for better future performance from his or her currently chosen options.

About One-Third of the Participants Responding To Our Survey Agreed That Program Fees Are Reasonable For the Services Provided

To find out about participants' satisfaction with the costs of the Deferred Compensation Program—administrative and investment management fees—we asked participants if they thought the fees charged were reasonable, and if the information provided by the Program concerning those fees was adequate. Participants were least satisfied with this aspect of the Program. In addition, their responses indicated some uncertainty about this area, as follows:

- In all, 36% of those responding to our survey said they thought the fees charged were reasonable. About 6% said the fees weren't reasonable. The rest either reported they didn't know or didn't have an opinion.
- 45% of those responding said they received adequate information about the Program's fees; 24% said they didn't get enough information

To help determine whether participants understood certain facts about how Program costs are paid, we asked participants in our sample whether it was true that expenses were deducted from their investment earnings, thus lowering their rate of return. Of those answering the question, 40% stated this wasn't true. However, for those invested in variable-return funds, this is a true statement. To ensure that State employees fully understand this aspect of the State's Deferred Compensation Program, Aetna will need to improve the information it provides in this area.

Conclusion

From the survey responses we received, it appears that the majority of participants in the Kansas Public Employees' Deferred Compensation Program are satisfied with the customer services of the Program. Fewer participants reported that they were happy with the investment performance of their money in the Program. However, they can help resolve that issue by changing the funds in which they place their money.

Participants reported least satisfaction with the fees being charged by the Program in relation to the services offered. Many reported that they thought they weren't receiving adequate information about the fees associated with the Program. In addition, many participants thought that money in the Program could be moved to other tax-deferred accounts such as an IRA or a 401(k). Money in a 457 deferred compensation plan can't be moved to other tax-deferred accounts. This is a restriction imposed by the Internal Revenue Service. It appears that the State and Aetna need to improve the information provided to employees about fees and restrictions on the money in the Program.

Recommendations

1. To ensure that State employees are aware of the fees and restrictions related to the State's Deferred Compensation Program, the Department of Administration should work with Aetna to improve the informational materials distributed to employees and the orientation seminars held about the Program, including ways to make certain that:
 - a. participants are aware of the administration and investment management fees, how those fees are paid, and what effect those fees have on the rates of return earned on their money in the Program.
 - b. participants are aware of the restrictions on money in the Program, including the fact that the money can't be used as a down payment on a house, for college expenses, or rolled into another tax-deferred account.
2. To ensure that State employees participating in the Deferred Compensation Program are kept informed about the Program and any changes in its fees or restrictions, the Department of Administration should work with Aetna to develop a way of providing information about the Program on an ongoing basis. This information could be included in participants' quarterly report or in a regular article about the Program in the *Kansagram*.

What Liability Does the State Have for Employees' Investments, Should Aetna Default or Mismanage Them?

State law clearly indicates the State isn't liable for any losses incurred by a participant in the State's Deferred Compensation Program, whether such losses may result from the ups and downs of the stock and bond markets, or from insolvency or mismanagement. However, in our opinion, State law is unclear as to whether participants' moneys in fixed-return accounts are covered by the Kansas Life and Health Insurance Guaranty Association if Aetna were to become insolvent. Aetna operates within a highly regulated industry. Although there can be no absolute guarantees that Aetna won't become insolvent, or that one of its investment managers won't mismanage funds, a significant number of controls and reviews are in place to monitor Aetna's operations. Such regulations should minimize the likelihood of such occurrences. In addition, there is limited protection of participants' money through Aetna's corporate liability insurance. Finally, recent changes in federal law regarding 457 deferred compensation plans will help protect participants' money from creditors in the unlikely event the State of Kansas should ever become insolvent. These and other findings are discussed in greater detail in the sections that follow.

The State Assumes No Liability for Losses Incurred by Program Participants in the Event of Insolvency or Mismanagement of Funds

When a State employee invests his or her money in the Deferred Compensation Program, that money isn't insured from the ups and downs of the stock market. This is an inherent risk of investing. The idea that you can lose money as well as make it by investing in the Program is made clear at presentations and in the contract State employees sign when joining the Program.

Aetna Investment Services, Inc. operates independently of Aetna insurance companies. Because of this separation, financial hardships that the insurance side of Aetna might incur would have no bearing on the financial health of Aetna Investment Services. Even though there is no risk of financial impairment from occurrences on the insurance side, there are potential risks from other events, including insolvency and mismanagement of funds.

According to K.S.A. 75-5524(c) "The state shall not be responsible for any loss incurred by an employee under the Kansas public employees deferred compensation plan..." The Department of Administration's Legal Department told us this statute supports the argument that the State will never be responsible for any loss incurred by an employee under the Program, including instances involving insolvency or mismanagement of Aetna. However, the Attorney General's Office explained that, as with any law, until an actual insolvency or mismanagement of funds occurred, and a case went to court, a definitive determination of the State's liability couldn't be made.

We contacted several national organizations to find out if any unit of government has ever been held liable for participant losses in the event of insolvency or mismanagement of funds. No one we spoke with knew of any instance in which a

third-party administrator or investment provider for a deferred compensation program ever became insolvent or mismanaged funds.

It's not clear from State law whether Program participants' moneys that are invested in Aetna's fixed-return accounts would be covered by the Kansas Life and Health Insurance Guaranty Association in the event Aetna should ever become insolvent. Kansas statutes relating to the Guaranty Association, which provides coverage for insurance companies doing business in Kansas, were written in 1972 before the State's Deferred Compensation Program was created in 1980. As a result, the relationship between the Association and the Program's accounts isn't clear. In addition, statutes relating to the State's Deferred Compensation Program don't address the issue of liability coverage by the Guaranty Association.

During this audit, we found a potential difference of opinion as to whether moneys invested in such fixed-return accounts would be covered by the Association if the Program's investment provider should ever become insolvent. The Guaranty Association Act provides coverage for "allocated" annuity contracts, but states that any "unallocated" annuity contracts aren't covered, and defines such contracts as ones that are "not issued to and owned by an individual." (One exception: the law does provide coverage for contracts for fixed-annuity benefits that participants may sign up for when they quit the Program.)

Because all moneys in the State's 457 deferred compensation program are required by the Internal Revenue Service to be held as assets of the State until participants quit the Program and withdraw their funds, we think it could be interpreted that participants' moneys are "not issued to and owned by an individual," and thus are "unallocated" and not covered. On the other hand, these accounts might be considered to be "allocated" because they are being held in trust on behalf of individual investors, and because investment providers send periodic statements to each participant about the status of his or her individual account.

Representatives from Aetna told us they think the moneys in the Program's fixed-return accounts are "allocated" annuity contracts, which would be covered by the Guaranty Association. They said that they've been treating participants' moneys in these accounts as "allocated" for reporting and assessment purposes.

Officials from the Kansas Guaranty Association told us their initial impression was that the contract was an "unallocated" annuity contract, which the Association is prohibited by law from providing coverage for. However, Association officials said they normally don't make such a determination until there's an actual case of insolvency, and they would need to do extensive research to be more definitive.

According to officials at the National Organization of Life and Health Insurance Guaranty Associations, a similar debate is going on at the national level among life and health insurance companies that offer financial services. Partly in response to this debate, the National Association of Insurance Commissioners currently is working on a new "model act" for state guaranty associations that should help clarify the difference between an allocated annuity contract and an unallocated one.

What makes this a potential issue in Kansas is that, in August 1992, in response to employees' questions about what would happen if Aetna were to become

insolvent, the Department of Administration sent a letter addressed to all State employees stating that moneys invested in the fixed-return accounts were covered by the Guaranty Association up to \$100,000. In essence, saying these accounts were covered defined them as "allocated" annuity contracts. However, officials we talked with at the Department of Administration and the Insurance Department weren't able to provide us with the basis they used in reaching this conclusion. They indicated the letter had been written by a former employee of the Insurance Department, and they were unable to locate any files related to this issue.

Because of the representations made in this letter, it's conceivable the State could be held liable for employees' losses if, in the unlikely event the Program's investment provider ever became insolvent, the Guaranty Association was successful in maintaining these funds weren't covered. In addition, participants may have made some investment decisions in the Program based on information provided in that letter.

Officials from Aetna indicated they planned to work with officials in the Insurance Department and the Department of Administration to try to resolve this issue. In addition, officials at the Kansas Guaranty Association told us this issue would be discussed at a future meeting of the Association's Board of Directors. But until State law is clarified, this issue could remain in doubt.

**Aetna Operates in a Highly Regulated Industry,
And the Controls Now in Place To Monitor Aetna's Overall Operations
Should Minimize the Likelihood of Insolvency or Mismanagement**

The State isn't liable for any losses incurred by an employee in the Program, but it does have a responsibility to contract with a reputable firm to administer the State's Deferred Compensation Program. Given the type of industry Aetna is involved in, numerous government agencies and national organizations are heavily involved in monitoring and regulating Aetna's operations and its "reliability" as an investment provider. Such regulatory efforts can't prevent all problems from occurring—and when they do occur the consequences can be substantial—but they are certain to minimize the likelihood of such occurrences.

Aetna is reviewed by several federal agencies, including the Securities and Exchange Commission. These reviews help ensure that Aetna follows federal mandates regarding the administration and investment of funds of a 457 deferred compensation plan. These agencies have the right to review Aetna's separate accounts, investment operations, and broker-dealer activities at any time, including the following:

- *Internal Revenue Service*—audits companies, like Aetna, to ensure that all laws and regulations relating to the operation and administration of deferred compensation plans are being followed
- *Securities and Exchange Commission*—regulates investment products, and the activities related to those products that investment providers offer to plan sponsors of 457 deferred compensation plans. The Commission conducts an audit of Aetna once every three years. The most recent audit was in January

Types of Deferred Compensation Plans Authorized by the IRS

Depending on the circumstances, government agencies may be able to offer their employees three deferred compensation plans authorized by the Internal Revenue Service: Sections 401(k), 403(b), and 457(b). In all three plans, employees may voluntarily defer compensation through payroll deductions. However, each plan has different features and different employee eligibility requirements. The following table describes those differences.

	<u>457 Plans</u>	<u>401(k) Plans</u>	<u>403(b) Plans</u>
Eligibility	State and local governments	State and local governments are prohibited from establishing, any new 401(k) plans after May 1986, although existing plans may continue	Only employees of public school systems, colleges, universities, and some tax-exempt charitable and other not-for-profit organizations, such as hospitals
Max. annual deferral	\$7,500	\$9,240	\$9,500
Can Move to IRA?	No	Yes	No
Additional Requirements?	None	The plan must benefit at least 50 employees, or 40% of all employees. It also can't favor highly compensated employees.	Same as 401(k) plan

1996. Aetna officials reported that corrective action was taken to address the minor deficiencies identified.

- *National Association of Securities Dealers, Inc.*—normally audits Aetna's broker-dealer operations every two years. The Association last audited Aetna in 1993, and is expected to audit Aetna in the near future. No written deficiencies were noted in the 1993 audit.

In addition, Aetna also is subjected to audits from the State's securities regulators, the State's insurance regulators, and Aetna's Corporate Internal Audit department. These audits are intended to alert Aetna and other officials to potential issues, and to give Aetna management the opportunity to address them before they become a problem. Any unresolved matters would be addressed by the Securities and Exchange Commission in a public proceeding.

Recent ratings by national organizations show Aetna to be a reputable company. Several different companies produce ratings, including A.M. Best Company, Moody's Investors Service, Standard and Poor's Corporation, and Duff and Phelps Investment Research Company. In the past year, Aetna received high ratings from each of these organizations as shown below:

- *A.M. Best (evaluates the financial and operating performance of insurance companies)*—rated Aetna A+ (Superior) as of July 1996. Under the current rating system, Aetna has received high ratings since 1979.
- *Moody's Investors Service (rates a company's ability to meet its long-term contractual obligations based on public and confidential information and meetings with the company's management)*—gave Aetna a financial strength

rating of Aa2 (Excellent). This rating was last reaffirmed in July 1996. Aetna has been rated by Moody's since June 1990.

- *Standard and Poor's (rates a company's ability to meet its long-term contractual obligations based on public and confidential information and meetings with the company's management)*—gave Aetna a rating of AA- (Excellent) as of July 1996. Aetna has been rated by Standard and Poor's since January 1990.
- *Duff & Phelps (rates a company's ability to meet its long-term contractual obligations based on public and confidential information and meetings with the company's management)*—since November 1994 has rated Aetna AA+ (Very High). This rating was reaffirmed in July 1996. Aetna has been rated by Duff & Phelps since November 1991.

As a Result of Aetna's Internal Precautionary Measures, Participants' Money in the Program Has Some Limited Protection

Aetna officials told us they couldn't offer any guarantees in the event the company became insolvent, or one of its investment managers mismanaged funds. However, Aetna has taken some precautions to help limit the impact in case an employee or investment manager didn't live up to his or her fiduciary duty.

First, Aetna officials said they select investment managers from respected firms within the investment management industry, such as Fidelity, Twentieth Century, Janus, Scudder, and Neuberger and Berman. Second, all its investment managers carry liability coverage of up to \$50 million each. Third, Aetna has purchased corporate liability insurance in the amount of \$60 million for any fraudulent or dishonest acts committed by its officers or employees.

Recent Changes in Federal Law Also Help Protect Participants' Money from Creditors In the Event the State Would Ever Become Insolvent

All money in the State's Deferred Compensation Program belongs to the State until participants quit the Program and withdraw their funds. This Internal Revenue Service requirement allows the moneys to accumulate tax-deferred, and is explained to employees when they join the Program. This requirement also protects a participant's money in the Program against creditors, in the event the employee declared bankruptcy. However, until this past September, that money wasn't protected against creditors in the unlikely event the State should ever become insolvent.

Since the situation in Orange County, California, legislative changes have been made to prohibit access to moneys held in deferred compensation programs. In September 1996, federal law related to governmental 457 deferred compensation plans require all moneys in the plan to be held in trust for the exclusive benefit of participants and their beneficiaries. Amounts held in trust aren't considered available to claims of the employer's—the State of Kansas—general creditors. In other words, with the new law, the loophole that allowed the State's creditors to claim the moneys in the Program was closed.

Conclusion

Since the State's Deferred Compensation Program began, thousands of State employees have invested millions of dollars in that Program. Although the Program's participants certainly understand that they may experience investment losses from their participation, they may not be as clear about their risk of other types of losses—from insolvency or mismanagement. Given how the Program is operated, the risk of such losses doesn't appear to be significant. Nevertheless, the State is responsible for evaluating these risks, addressing them where possible, and keeping participants appropriately informed.

Recommendations

1. To ensure that State law is clarified regarding whether participants' moneys in the fixed-return accounts of the State's Deferred Compensation Program are covered by the Kansas Life and Health Insurance Guaranty Association, in the event an investment provider should ever become insolvent, the Legislative Post Audit Committee should do one of the following:
 - a. If the Legislature's intent is to have participants' moneys in these fixed-return accounts covered by the Guaranty Association, the Legislative Post Audit Committee should draft legislation clearly stating this fact. As a starting point, it should consider language in the new "model act" being developed by the National Association of Insurance Commissioners.
 - b. If the Legislature's intent is that participants' moneys in these fixed-return accounts should not be covered by the Guaranty Association, the Legislative Post Audit Committee should draft legislation clearly stating that fact.
2. If legislation is passed clarifying whether fixed-return accounts are covered by the Kansas Guaranty Association, the Department of Administration should notify all Program participants of those changes.
3. To ensure that the State's Deferred Compensation Program is consistent with current federal law, the Department of Administration should do the following:
 - a. prepare draft legislation bringing the State's law into compliance with recent changes made in the federal law regarding 457 deferred compensation plans.
 - b. change the State's Deferred Compensation Plan to incorporate the recent changes in federal law.

APPENDIX A

457 Deferred Compensation Programs in Kansas and Six Nearby States

To help determine if Kansas' 457 Deferred Compensation Program is providing State employees good quality service at a reasonable cost, we contacted six nearby states—Arkansas, Colorado, Iowa, Missouri, Nebraska, and Oklahoma. This appendix lists the general information we gathered about these states' and Kansas' deferred compensation programs.

457 DEFERRED COMPENSATION PROGRAMS IN SIX NEARBY STATES			
AS OF JUNE 30, 1996	KANSAS	ARKANSAS	COLORADO
Administering Agency	Department of Administration	Office of Personnel Management	Department of Personnel
Division	Personnel Services and Accounts and Reports	Department of Finance and Administration	Employee Benefits Unit
Program Administrator	Aetna	First Variable Life and Variable Annuity Life	Security First Group
Year Program Began	1980	1975	1981
Program Assets (in millions)	\$210	\$111	\$210
In Fixed Return Funds (in millions)	\$104	\$75	Don't Know
In-Variable Return Funds (in millions)	\$106	\$36	Don't Know
Number of Participants	13,658	5,832	8,500
Percentage of Eligible Employees	24%	20%	20%
Number of Eligible Employees	Classified, Unclassified, Legislative, and Appointed	Classified, Unclassified, Legislative, and Appointed	Classified, Unclassified, Legislative, and Appointed
Number of Providers	1	2	7
Number of Investment Options Offered	30	25	13
Frequency of Statements	Quarterly	Quarterly	Quarterly
Free Investment Changes Per Year	Twice a month	Monthly	Daily
Third-party Administrator Fees	.95% on Variable Funds	1 - 1.25% on Variable Funds	\$12 Per Year
A Flat Fee or a Percentage of Assets	Percentage of Assets	N/A	Both
State Program Fees	None	None	.25% of Assets Per Quarter
Administrator Fees Decrease as Fund Assets Increase	Yes	N/A	No
Miscellaneous Administrator Fees	No	No	No

SERVICES PROVIDED FOR DEFERRED COMPENSATION PARTICIPANTS			
AS OF JUNE 30, 1996	KANSAS	ARKANSAS	COLORADO
Employee Educational Seminars and Personnel Department Staff Training	Yes	Yes	Yes
Fund Transaction and Transfer Processing	Yes	Yes	Yes
Handling of Complaints and Problems	Yes	Yes	Yes
Quarterly and Annual Statements	Yes	Yes	Yes
Activity Statements and Account Balances	Yes	Yes	Yes
Other Miscellaneous Services Provided	No	No	No

STATE OVERSIGHT OF DEFERRED COMPENSATION PROGRAM			
AS OF JUNE 30, 1996	KANSAS	ARKANSAS	COLORADO
State Oversight of the Program	Minimal	Insurance board monitors program, with the help of a contracted consulting firm	Department reviews plan quarterly; a consultant reviews plan annually
State Approves Investment Options	Yes	No	Yes
Administrator Reports Required by the State	None Required	Monthly: assets, participants, contributions, terminations, company financial and ratings	Monthly: financials, activity detail, investment reports, and phone response rate
Does Administrator Report to a Legislative Committee	No	No	Yes, the Legislative Audit Committee
Reports Required by Legislative Committee	None Required	None Required	Annual financial audit; performance audit as deemed necessary
Program Expenses Paid by State	None	None	None
State Liability if Provider becomes Insolvent or Mismanages Funds	None	None	None
Frequency Bids Are Opened to Outside Administrators	Not since inception of plan	As deemed necessary by insurance board	5-year contract, with 3-year renewal option

457 DEFERRED COMPENSATION PROGRAMS IN SIX NEARBY STATES

IOWA	MISSOURI	NEBRASKA	OKLAHOMA
Department of Personnel	Office of Administration	Nebraska Public Employee Retirement System	Oklahoma Public Employee Retirement System
Deferred Compensation Division	Office of Administration, Employee Benefits	Retirement Office	Retirement Office
Department of Personnel	Public Employees Benefit Services	Hartford	T. Rowe Price
1974	1980	1976	1979
\$130	\$439	\$70	\$160
Don't Know	Don't Know	\$17	\$104
Don't Know	Don't Know	\$53	\$56
8,000	33,000	3,275	6,740
38%	55%	19%	18%
Classified, Unclassified, Legislative, and Appointed	Classified, Unclassified, Legislative, and Appointed	Classified, Unclassified, Legislative, and Appointed	Classified, Unclassified, Legislative, and Appointed
40	4	1	3
about 60	29	18	33
Quarterly	Quarterly	Quarterly	Quarterly
Varies with Contracts	Daily	Bi-Weekly & Monthly	Monthly
Fees Vary with Contracts	Fees Vary with Contracts	Fees Vary with Contracts	\$5 Per Year
Combination of both; depends upon providers' contracts	Percentage of assets	Hartford charges asset based fee: State charges \$20 per year	Flat
None	None	\$20 Per Year	\$3 Per Year
Varies with Contracts	No	NO	No
No	Yes	Yes	No

SERVICES PROVIDED FOR DEFERRED COMPENSATION PARTICIPANTS

IOWA	MISSOURI	NEBRASKA	OKLAHOMA
Yes	Yes	Yes	Yes
Yes	Yes	Yes	Yes
Yes	No	Yes	Yes
Yes	Yes	Yes	Yes
Yes	Yes	Yes	Yes
No	No	No	No

STATE OVERSIGHT OF DEFERRED COMPENSATION PROGRAM

IOWA	MISSOURI	NEBRASKA	OKLAHOMA
Department audits plan annually, and authorizes policy changes	Department reviews plan quarterly	Department audits plan annually; contribution totals checked monthly	Consultant reviews plan and investments semi-annually
No	Yes	Yes	Yes
Annual audit	Quarterly: participation, withdrawal, and termination Monthly: investment earnings	Semi-annual: contributions and withdrawals Quarterly: lump sum allocations	Monthly: detail of assets, contribution, termination, investment, and other requests
No	Yes, the Deferred Compensation Committee	Yes, the Retirement Board	No
None Required	Quarterly statistical detail, and other business the board wants to discuss	Annual Report	None Required
Salary and Expenses for 2.5 Full Time Employees	Board Travel Expenses; about \$2500 Per Annum	None	Salaries and some Marketing; about \$150,000 Per Annum
None	None	None	Don't Know
Never	Every 4 to 5 years	Council began process to open bids 7-1-96	1-year contract, usually renewed for 4 years

APPENDIX B

Comparison of Rate of Returns Earned by Investments In the Kansas Public Employees' Deferred Compensation Program To the Rate of Returns Earned by Comparable Standard Indices

This appendix compares the rates of return earned by the 30 funds available to participants in the State's Deferred Compensation Program to the rates of return earned by each fund's comparable standard index. The rates of return shown in this appendix are after all the administration and fund management fees have been deducted. The standard indices have no fees. The rates of return are reported as of June 30, 1996. Aetna provided this information.

Funds offered in the State's Deferred Compensation Program	Rates of Return for 3 years		Rates of Return for 5 years		Rates of Return for 10 years	
	Program Funds (all fees deducted)	Comparable Indices (no fees deducted)	Program Funds (all fees deducted)	Comparable Indices (no fees deducted)	Program Funds (all fees deducted)	Comparable Indices (no fees deducted)
Stock Funds						
Aetna Ascent Variable (a)						
Aetna GET Fund-Series B (a)						
Aetna Legacy Variable (a)						
Aetna Variable Fund	13.93	17.25	12.28	15.75	11.83	13.76
Alger American Growth (b)	18.55	17.25	18.86	15.75		
Alger American Small Cap (b)	18.36	17.10	17.01	15.97		
Fidelity VIP Equity-Income (b)	16.54	17.25	17.83	15.75		
Fidelity VIP Growth (b)	15.94	17.25	18.80	15.75		
Fidelity VIP Contrafund (a)						
Janus Aspen Aggressive Growth Portfolio (a)						
Janus Aspen Growth (a)						
Lexington Natural Resources Trust Fund (c)	4.98	17.25				
Neuberger & Berman Advisors Mgmt. Trust	10.94	17.25	11.55	15.75	9.83	13.76
TCI Growth Fund (b)	10.63	18.34	11.84	15.57		
Balanced Funds						
Aetna Crossroads Variable (a)						
Aetna Investment Advisors (b)	11.45	12.36	10.75	12.78		
Calvert Responsibly Invested Balanced Fund (b)	9.54	10.23	9.65	11.82		
Janus Aspen Balanced (b)						
International Funds						
Fidelity VIP Overseas (b)	10.33	10.76	9.07	10.33		
Janus Aspen Worldwide Growth Portfolio (a)						
Scudder VLIF International (b)	11.98	10.76	10.29	10.33		
Bond Funds						
Aetna Income Shares	4.26	5.27	7.42	8.26	7.94	8.55
Franklin Government Securities Trust (b)	4.86	4.94	6.45	6.27		
Janus Aspen Flexible Income (a)						
Janus Aspen Short Term Bond Portfolio (a)						
Money Market Funds						
Aetna Variable Encore Fund	3.79	4.26	3.56	4.00	5.12	5.45
Fixed Funds						
Aetna Fixed Fund	6.29	n/a	6.88	n/a	7.83	n/a
Aetna Fixed Plus Fund	6.49	n/a	6.99	n/a	7.88	n/a
Guaranteed Funds						
Aetna Guaranteed Accumulation - short term (d)						
Aetna Guaranteed Accumulation - long term (d)						

- (a) The Program hasn't offered this fund long enough to have a 3, 5, or 10 year rate of return
(b) The Program hasn't offered this fund long enough to have a 5 or 10 year rate of return
(c) The Program hasn't offered this fund long enough to have a 10 year rate of return
(d) This fund doesn't have annualized rates of return

APPENDIX C

457 Deferred Compensation Programs in States With Aetna Investment Services

To help determine if Kansas' 457 Deferred Compensation Program is providing State employees good quality service at a reasonable cost, we contacted nine states that use Aetna Investment Services as a third-party administrator or an investment provider—Connecticut, Florida, Maine, Mississippi, Oregon, Rhode Island, Tennessee, Texas, and Vermont. This appendix lists the general information we gathered about these states' deferred compensation programs, including the Kansas Public Employees' Deferred Compensation Program.

STATES WHERE AETNA IS AN INVESTMENT PROVIDER FOR DEFERRED COMPENSATION PROGRAMS					
AS OF JUNE 30, 1996	KANSAS	CONNECTICUT	FLORIDA	MAINE	MISSISSIPPI
Third-Party Administrator	AETNA	FINANCIAL AND INVESTMENT SERVICES	FRINGE BENEFITS CORPORATION	ADMINISTERED IN-HOUSE	SYSTEMIZED BENEFITS ADMINISTRATORS subsidiary of Aetna
Total Fund Assets (in millions)	\$210	\$300	\$750	\$100	\$275
Assets in Aetna (in millions)	\$210	\$280	\$14	\$55	\$210
Year Aetna Became a Provider	1980	1974	1982	1975	1974
Number of Investment Providers	1	4	8	3	9
Number of Investment Options	30	120	70	don't know	10
Number of Aetna Options Offered	30	30	10	30	4
State Approves Investment Options	Yes	Yes	Yes	No	Yes
Number of Participants	13,658	18,000	42,000	3,200	17,474
Number of Eligible Participants	58,000	60,000	150,000	13,000	145,000
Rate of Participation	24%	30%	28%	25%	12%
Number of Aetna-Participants	13,658	12,000	14,000	2,500	17,474
Aetna Rate of Participation	24%	20%	9%	19%	12%
Average Assets Per Participant	\$15,376	\$23,333	\$1,000	\$22,000	\$12,018
Minimum Annual Contribution	\$300	\$520	\$240	\$300	\$180

SERVICES PROVIDED BY AETNA					
AS OF JUNE 30, 1996	KANSAS	CONNECTICUT	FLORIDA	MAINE	MISSISSIPPI
Frequency of Participant Statement	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly
Investment & Retirement Counseling	Yes	Yes	Yes	Yes	Yes
Employee Informational Seminars & Personnel Staff Training	Yes	Yes	Yes	Yes	Yes
Handling of Participant Complaints	Yes	Yes	Yes	Yes	Yes
On-site Participant Enrollment	Yes	Yes	Yes	Yes	Yes
Free Investment Changes Per Year	24	24	24	24	52

FEES CHARGED BY AETNA					
AS OF JUNE 30, 1996	KANSAS	CONNECTICUT	FLORIDA	MAINE	MISSISSIPPI
Program Fees Paid by Participants	Yes	Yes	Yes	Yes	Yes
State Subsidy of Program Fees	None	None	None	None	None
Annual Fee for Program	None	None	None	None	None
Fee (as a % of Assets Managed)	.95%	1.25%	1.25%	.95%	1.25%
Program Fees Decrease as Fund Assets Increase	Yes	Yes	Yes	Yes	Yes
A Surrender Fee Is Charged for Early Withdrawal from Program	None Since 1990	If Fixed Funds Are Transferred to Another Provider Before 10 Years	If Fixed Funds Are Transferred to Another Provider Before 10 Years	If Fixed Funds Are Transferred to Another Provider Before 10 Years	None
Other Miscellaneous Fees Charged	None	None	None	None	None

STATES WHERE AETNA IS AN INVESTMENT PROVIDER FOR DEFERRED COMPENSATION PROGRAMS					
AS OF JUNE 30, 1996	OREGON	RHODE ISLAND	TENNESSEE	TEXAS	VERMONT
Third-Party Administrator	ADMINISTERED IN-HOUSE	ADMINISTERED IN-HOUSE	SECURITY FIRST GROUP	47 THIRD-PARTY ADMINISTRATORS	SYSTEMIZED BENEFITS ADMINISTRATORS subsidiary of Aetna
Total Fund Assets (in millions)	\$327	\$86	\$100	\$254	\$65
Assets in Aetna (in millions)	\$73	\$58	\$25	\$30	\$65
Year Aetna Became a Provider	1983	1979	1981	1974	1980
Number of Investment Providers	8	2	4	47	8
Number of Investment Options	38	35	12	282	13
Number of Aetna Options Offered	9	14	1	30	4
State Approves Investment Options	Yes	Yes	Yes	Yes	Yes
Number of Participants	13,000	2,565	4,500	11,000	4,000
Number of Eligible Participants	38,000	16,000	40,000	262,000	7,500
Rate of Participation	34%	16%	11%	4%	53%
Number of Aetna Participants	3,000	2,500	2,500	2,500	2,800
Aetna Rate of Participation	8%	16%	6%	1%	37%
Average Assets Per Participant	\$24,333	\$23,200	\$10,000	\$12,000	\$23,214
Minimum Annual Contribution	\$300	\$300	\$180	\$300	\$300

SERVICES PROVIDED BY AETNA					
AS OF JUNE 30, 1996	OREGON	RHODE ISLAND	TENNESSEE	TEXAS	VERMONT
Frequency of Participant Statement	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly
Investment & Retirement Counseling	No	Yes	Yes	Yes	Yes
Employee Informational Seminars & Personnel Staff Training	No	Yes	Yes	Yes	Yes
Handling of Participant Complaints	Yes	Yes	Yes	Yes	Yes
On-site Participant Enrollment	Yes	Yes	Yes	Yes	Yes
Free Investment Changes Per Year	24	24	24	24	24

FEES CHARGED BY AETNA					
AS OF JUNE 30, 1996	OREGON	RHODE ISLAND	TENNESSEE	TEXAS	VERMONT
Program Fees Paid by Participants	Yes	Yes	Yes	Yes	Yes
State Subsidy of Program Fees	None	None	None	None	None
Annual Fee for Program	None	None	None	\$15	None
Fee (as a % of Assets Managed)	1.25%	1.25%	1.25%	1.25%	1.15%
Program Fees Decrease as Fund Assets Increase	Yes	Yes	Yes	Yes	Yes
A Surrender Fee Is Charged for Early Withdrawal from Program	None	If Fixed Funds Are Transferred to Another Provider Before 10 Years	If Fixed Funds Are Transferred to Another Provider Before 10 Years	If Fixed Funds Are Transferred to Another Provider Before 10 Years	None
Other Miscellaneous Fees Charged	None	None	None	None	None



APPENDIX D

Summary of Survey Responses from Participants In the Kansas Public Employees' Deferred Compensation Program

On July 30, 1996, we mailed surveys to 613 participants in the State's Deferred Compensation Program to obtain their opinions about the handling of complaints, information provided about the Program, investment performance, and administration and investment management fees. We also included a true/false test to determine if participants knew and remembered information about the Program we thought was important in deciding whether to join. Overall, 285 responded, for a response rate of 47%. The sample included three groups of participants:

- *active participants*—those employees who were contributing to the Program during fiscal year 1996
- *inactive participants*—those employees who were enrolled in the Program, but weren't making contributions during fiscal year 1996
- *participants receiving benefit payments*—those employees who had quit the Program and received a benefit payment during fiscal year 1996

This appendix is a summary of the responses we received from all three groups. The correct answers to the true/false questions are indicated by a circle around the number responding. We eliminated the true/false test from the surveys returned by the participants receiving benefit payments because the correct answers could vary, depending on the type of benefit payment they are receiving.

Also, in addition to the questions summarized on the following pages, inactive participants were asked the following:

- **Why did you stop contributing to the Program? (Please check the reason that best explains why.)** (7 surveys had no response to this question.)

11 I needed the money for current expenses

33 Other (Please explain)
7 quit working for the State
20 retired from the State
6 wrote multiple reasons

Deferred Compensation Survey

The Legislative Post Audit Committee has directed the Legislative Division of Post Audit to conduct a performance audit of the State Deferred Compensation Program. One of the objectives of the audit is to determine if State employees are satisfied with the services provided under this program. To help us meet this objective, we are conducting a survey of State employees who participate in the Deferred Compensation Program.

We would appreciate it if you would take the time to answer the following questions. The returned surveys will be included in the audit working papers which will become part of a public document once the audit is completed. Please return the completed survey in the enclosed, self-addressed, postage-paid envelope by **Friday, August 16, 1996**. If you have any questions related to the survey, please contact Trish Pfannenstiel at (913) 296-5817 or Barbara Reed at (913) 296-5180 or write them at Legislative Post Audit, 8th and Jackson, Topeka, KS 66612.

1. In about what year did you join the State's Deferred Compensation Program? 1987
(average start date)

For the questions below, please check the appropriate box.

2. Have you ever found any mistakes in the amount deducted from your paycheck for the Program? (1 survey had no response.)

278 No If no, go to **Question 3**
 5 Yes If yes, were those errors corrected in a timely manner? 5 Yes 0 No

3. Have you ever found any mistakes in your quarterly reports for the Program? (13 surveys had no response to this question.)

269 No If no, go to **Question 4**
 3 Yes If yes, were those mistakes corrected in a timely manner? 1 Yes 1 No
(1 blank)

4. Have you ever complained about the Program? (3 surveys had no response to this question.)

269 No If no, go to **Question 5**
 13 Yes If yes, were you satisfied with the way the complaint was resolved? 7 Yes 4 No
(2 blanks)

Who did you complain to? (please check the appropriate box)

6 Aetna 1 Division of Accounts and Reports
 1 Division of Personnel Services 1 A personnel representative in your agency
 0 Other (please list) (1 survey had no response and 1 had multiple answers)

5. Have you ever asked Aetna about the Program or the investments Aetna offers? (8 surveys had no response to this question.)

60 No If no, go to **Question 6**
 217 Yes If yes, was the person(s) at Aetna courteous? (4 blanks) 212 Yes 1 No
 Was your question answered to your satisfaction? (7 blanks) 205 Yes 5 No

For the questions below, please check the box that best describes your opinion about the following statements.

6. In my opinion, Aetna gave me enough information to decide that joining the Program was the right choice for me. (4 surveys had no response to this question.)

108 Strongly Agree 145 Agree 21 Neither Agree Nor Disagree 6 Disagree 1 Strongly Disagree 0 Don't Know

7. In my opinion, Aetna gives me enough information about the administration fees it charges to operate the Program. (3 surveys had no response to this question.)

32 Strongly Agree 103 Agree 65 Neither Agree Nor Disagree 42 Disagree 24 Strongly Disagree 15 Don't Know

8. In my opinion, Aetna gives me enough information about the fees the investment managers charge to invest my money. (4 surveys had no response to this question.)

26 Strongly Agree 92 Agree 71 Neither Agree Nor Disagree 47 Disagree 22 Strongly Disagree 23 Don't Know

9. In my opinion, Aetna gives me enough information about the investment options I can pick from. (4 surveys had no response to this question.)

67 Strongly Agree 172 Agree 24 Neither Agree Nor Disagree 11 Disagree 3 Strongly Disagree 4 Don't Know

10. In my opinion, the administration fees Aetna charges are reasonable for the services provided. (2 surveys had no response to this question.)

18 Strongly Agree 91 Agree 84 Neither Agree Nor Disagree 9 Disagree 7 Strongly Disagree 74 Don't Know

11. In my opinion, the fees investment managers charge for investing my money is reasonable. (3 surveys had no response to this question.)

18 Strongly Agree 79 Agree 86 Neither Agree Nor Disagree 10 Disagree 6 Strongly Disagree 83 Don't Know

12. In my opinion, Aetna gives me enough information about how my investments are doing. (5 surveys had no response to this question.)

48 Strongly Agree 175 Agree 26 Neither Agree Nor Disagree 25 Disagree 2 Strongly Disagree 4 Don't Know

13. I am happy with the rate of return I earn on my money in the Program. (2 surveys had no response to this question.)

27 Strongly Agree 120 Agree 42 Neither Agree Nor Disagree 18 Disagree 6 Strongly Disagree 2 Don't Know

14. In my opinion, Aetna makes it easy to make changes to my investment accounts. (4 surveys had no response to this question.)

38 Strongly Agree 133 Agree 33 Neither Agree Nor Disagree 2 Disagree 2 Strongly Disagree 9 Don't Know

15. In my opinion, Aetna gives me information about the Program as often as I need it. (3 surveys had no response to this question.)

54 Strongly Agree 170 Agree 37 Neither Agree Nor Disagree 14 Disagree 2 Strongly Disagree 5 Don't Know

16. In my opinion, Aetna gives me enough information about how I will be able to withdraw my money from the Program when I retire. (2 surveys had no response to this question.)

47 Strongly Agree 111 Agree 52 Neither Agree Nor Disagree 38 Disagree 15 Strongly Disagree 20 Don't Know

Based on the information that you have been provided about the Kansas Deferred Compensation Program, please indicate if you think the following statements are true or false. (Only the active and inactive participants responses are summarized below. The correct answer is circled.)

	True	False
17. I can take my money out of the Deferred Compensation Program, while still employed with the State, to help buy a house. (10 Surveys had no response to this question and 10 had "don't know.")	19	187
18. The money I've put into the Program is insured by the State of Kansas just as money in banks is insured by the FDIC. (9 surveys had no response to this question and 30 had "don't know.")	47	148
19. I can only make changes to my deductions or investment choices once a year. (8 surveys had no response to this question and 2 had "don't know.")	20	187
20. To pay for the Program, expenses (such as administrative and investment management fees) are deducted from my investment earnings, lowering my rate of return. (21 surveys had no response to this question and 2 had "don't know.")	116	78
21. I can take my money out of the Program, while still employed with the State, to help pay for college expenses. (11 surveys had no response to this question and 1 had "don't know.")	24	181
22. I can make money as well as lose money in the Program. (3 surveys had no response to this question and 10 had "don't know.")	203	10
23. My deferred compensation benefits are not connected to my KPERS benefits. (4 surveys had no response to this question.)	210	3
24. If I quit the State, I can put my deferred compensation money into an IRA or 401(k) to continue delaying paying taxes on that money. (8 surveys had no response to this question and 3 had "don't know.")	144	62
25. The only way I can take my money out of the Deferred Compensation Program, while still employed with the State, is for an unforeseeable financial emergency, as approved by the State. (10 surveys had no response to this question.)	178	29
26. The State pays all expenses (such as administration and management fees) for the Program. (18 surveys had no response to this question and 4 had "don't know.")	29	166

APPENDIX E

Agency Responses

On October 3, 1996, we provided a draft copy of the audit report to the Department of Administration and Aetna Investment Services, Inc. Their responses are included in this appendix. We also provided the Kansas Life and Health Insurance Guaranty Association a draft of the audit section related to their Association. The Association chose not to respond.



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DEPARTMENT OF ADMINISTRATION

October 11, 1996

Barbara J. Hinton
Legislative Post Auditor
Legislative Division of Post Audit
800 S.W. Jackson, Suite 1200
Topeka, Kansas 66612-2212



Dear Ms. Hinton:

Thank you for providing us the opportunity to review your Legislative Post Audit report. We are pleased to respond to the audit "Reviewing the Kansas Public Employees' Deferred Compensation Program." Your audit is comprehensive and staff has done a commendable job in their research. What follows is a summary of our response to several issues brought to our attention.

The Deferred Compensation Program began in 1980 with 500 state employees enrolled in the program. Currently, nearly 10,000 employees are active participants. As part of our overall compensation and benefits program, we feel the Deferred Compensation Program offers attractive financial options to our workforce.

We were pleased to read your survey results of employee satisfaction with the Program. Employees are pleased with the number of options available and the customer services made available to them by the provider.

Officials from the Department of Administration concur that administrative oversight of the Deferred Compensation Program is necessary. We do not agree with your statement on page 18 "Kansas hasn't had oversight of its Deferred Compensation Program for the past one-and-one half years..." Representatives from the Division of Personnel Services (DPS) have continual contact with the provider including annual meetings with the top investment and financial managers of Aetna. The Division has focused on the employee perspective of the issues. For example, DPS has worked with Aetna to improve communications concerning hardship withdrawal requirements. Additionally, the Division has included Aetna presentations at several of the semi-annual statewide Human Resources Conferences. At these conferences, employees and agency personnel officers have an opportunity to communicate with Aetna in a group setting and learn about the program. Of course, officials from Aetna communicate directly with employees regarding the different investment options available. We

Barbara J. Hinton
October 11, 1996
Page 2

are supportive of increased employee efforts and responsibility to understand investment options and risks. We agree that additional attention from Department of Administration to the Program could be beneficial.

The Division plans to continue our oversight efforts and to implement several of the formal audit procedures recommended on page 19. Although DPS recognizes the value of identifying specific duties in statute, the Division will incorporate those audit procedures in our standard operating procedures as well as developing additional oversight. Soon, I will establish an oversight committee comprised of Department of Administration officials who will meet quarterly to oversee the program and make recommendations.

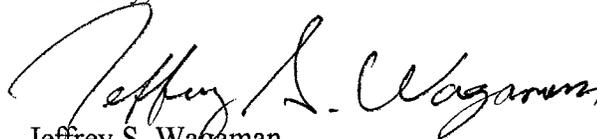
Although we feel our procedures for handling customer complaints are adequate, we will develop formalized procedures. Our files show we have received only one written complaint in the last seven years.

DPS agrees that although there is detailed information in the prospectus of every investment vehicle regarding the administration and investment of management fees, participants may not universally understand the impact of those fees. The oversight committee will work with Aetna to develop more comprehensive and understandable information about fees. The Division will also work with Aetna to develop more formalized information regarding hardship withdrawal requirements and options for participation after separation of employment.

I agree with the recommendation that the state should work with Aetna to draft legislation incorporating into state law the recent amendments to Internal Revenue Code § 457 regarding public deferred compensation plans. The essence of the recent amendment to IRC § 457 requires that assets in state government deferred compensation plans be held "in trust" for the exclusive benefit of participants and their beneficiaries. Such legislation would preclude the state from borrowing against the Plan's assets and would prevent the state's creditors from being able to attach assets of the Plan. Also, note that compliance with the amendment to IRC § 457 is required for the Plan to continue its tax deferred status.

The overall quality of your report is high and we support your basic findings. Reports such as these serve as a valuable tool in helping the executive branch provide service to our customers. The Department of Administration is pleased to provide a balanced array of employee benefits to our state workforce, including the Deferred Compensation Program.

Sincerely,

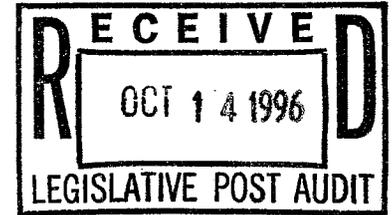


Jeffrey S. Wagaman
Acting Secretary of Administration



Aetna Investment Services, Inc.
Kansas Deferred Compensation Plan
400 W. 8th Street, Suite 104
Topeka, KS 66603
913-296-7095
Fax: 913-296-1776
1-800-232-0024

October 11, 1996



Barbara Hinton
Legislative Post Auditor
800 SW Jackson Ste 1200
Topeka Ks 66612

Dear Ms. Hinton,

We certainly appreciate the opportunity to review the draft copy of the performance audit on the Kansas Public Employees Deferred Compensation Program. By agreement with your office, additional comments may be filed from the Aetna Hartford Office by October 18.

We have met with the Directors of the Divisions of Personnel Services and Accounts and Reports to start the process of Plan revisions to reflect the changes brought about by the passage of HR 3488. While most of the changes are not effective until 1-1-97 it was agreed that we would provide the Directors with a draft of suggested changes by 11-4-96 to allow time for implementation and notification to all concerned parties. We will be meeting with the Director of Personnel Services to develop ways to improve the knowledge level of Plan participants and to keep them aware of all changes to the plan and this will be on an ongoing basis. It is interesting that the area that stands out the most on the enrollment certificate, (copy attached) relating to moving money to an IRA, which is reviewed and signed by each new participant, is the area they failed to remember when completing the survey. Also the lack of knowledge of fees by many of the Plan Participants may be a reflection of the fact that 23 % of plan participants are totally invested in the fixed accounts and an additional 25% are substantially invested in the fixed account. Fixed accounts operate like other guaranteed rate products available from a variety of financial institutions. The institution guarantees a rate of return and does not charge a separate fee. Instead, the institution must recover any cost which they incur and make a profit by out performing the guarantee they offer. Therefore, it is understandable why a large number of participants were unaware of fees under the Plan.

In addition in Appendix A the number of free investment changes as it relates to Kansas should be unlimited/daily. Also it should be noted that while basically all State Employees are eligible for the Plan, the Regents employees are eligible for 403(b) TDA which has higher limits and individual ownership and therefore we do not actively solicit their participation under the Plan. The percentage of non Regent full time State employees participating in the Plan would be in the 45% range.

Should you have any questions please let me know.

Sincerely,

Charles T. Kreiser
Regional Manager

**STATE OF KANSAS '457' DEFERRED COMPENSATION PLAN
ENROLLMENT CERTIFICATION**

In order to ensure that each new Participant has the basic information on the State of Kansas Deferred Compensation Plan, we have developed the following checklist:

1. A copy of the **State of Kansas Deferred Compensation Plan** has been made available.
2. A copy of the **Plan Booklet** has been supplied.
3. The current **Aetna Prospectuses** have been supplied.
4. A copy of the **Joinder** reflecting my initial salary reduction and beneficiary has been supplied.
5. The following administrative procedures have been explained:
 - a. The State of Kansas is the owner of all funds until actually paid to me.
 - b. Participation in a 403B, 401K, or a SEP Plan may affect the amount you may contribute, therefore, it is agreed you will notify us should you become eligible under any such plan.
 - c. My agreement to defer income must be made **prior to the beginning** of the payroll period.
 - d. That changes can only be made once each **90 days**; however, I may stop prior to the start of any payroll period.
 - e. That contributions are invested **when received by Aetna**.
 - f. That Federal and State income tax withholdings will be calculated on my reduced income unless I have elected an **arbitrary withholding**, in which case they may be calculated on **unreduced** income.
 - g. That the value of contributions made into the various Mutual Funds **will vary depending upon the value of investments** and could result in either a profit or loss to my account.
 - h. That new interest rates and guaranteed term will be announced periodically for the Guaranteed Accumulation Account (GAA), and that funds withdrawn or transferred from the GAA prior to the end of a guaranteed term are subject to a market value adjustment.
 - i. There is currently no **maintenance fee**, however the contractual maximum amount could be fifteen dollars annually.
 - j. That a deferred sales charge may be made against my account at payout **unless** one of the following apply: I have terminated employment, my account is 10 years old, account value is being applied to a settlement option, being paid to my beneficiary in the event of my death, or under the hardship provision of the Plan.
 - k. That at **NO TIME** can my Deferred Compensation Plan be rolled into an IRA.
 - l. That in the event of my termination of employment, for any reason, I will notify the Deferred Compensation Office at 400 W. 8th St. Topeka, Ks. 66603, 1-800 232-0024 or 913 296-7095, so appropriate action can be taken.
6. I understand that I may withdraw funds **ONLY** at retirement, disability, death, termination of employment, or for "financial emergencies" beyond my control. Withdrawals for foreseeable expenditures normally budgetable, such as down payment on a home, purchase of automobile, expenses normally associated with childbirth, or college expenses, will not be permitted. I further understand that I **should** maintain sufficient savings outside of the Plan to be able to meet budgetable and minor unexpected expenses.

This certifies that I have been supplied with the above information and understand that, while these are the highlights of the State of Kansas Deferred Compensation Plan, the complete details are found **only** in the Plan Document which has been made available.

Participant

Enrolling Agent

DATE



151 Farmington Avenue
Hartford, CT 06156

Timothy F. Bannon
Counsel
Law and Regulatory Affairs, RC4A
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Fax: 860-273-8340

October 18, 1996

Ms. Barbara J. Hinton
Legislative Division of Post Audit
Mercantile Bank Tower
800 Southwest Jackson Street, Suite 1200
Topeka, Kansas 66612-2210



Re: Your Draft Report - "Reviewing the Kansas Public Employees' Deferred
Compensation Program"

Dear Barbara:

Here are some revisions to the October 17 letter. Please use this to replace the letter in your appendix. Thanks very much.

Sincerely,

Timothy F. Bannon
Counsel



151 Farmington Avenue
Hartford, CT 06156

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October 18, 1996

REVISED



Ms. Barbara J. Hinton
Legislative Division of Post Audit
Mercantile Bank Tower
800 Southwest Jackson Street, Suite 1200
Topeka, Kansas 66612-2210

Re: Your Draft Report - "Reviewing the Kansas Public Employees' Deferred Compensation Program"

Dear Ms. Hinton:

First, let me thank you and your staff for meeting with me and my colleague, Mr. Steinhilber, on Wednesday, October 16, 1996. We appreciate the time you spent with us on the issues raised about guaranty fund coverage for fixed-return accounts in the Kansas Public Employees' Deferred Compensation Plan.

And let me reiterate at the outset that we share your desire that the law with respect to guaranty fund coverage of insurance products be clear. In the case of the Aetna Life Insurance and Annuity Company ("ALIAC") contract which funds the Plan, we think the law is clear: under Kansas law, the fixed-return accounts are covered.

Based on the Kansas life and health insurance guaranty association act, we have filed premium reports with the Kansas Life and Health Insurance Guaranty Association which plainly indicate that the fixed-return accounts are covered. The Kansas Life and Health Insurance Guaranty Association has accepted those reports and made assessments against Aetna based on them. We have paid those assessments and stand ready to continue to do so as long as the law remains as it is.

On the other hand, if the legislature believes the law is not clear, we -- as do you -- believe the legislature should act. Whether it acts in a manner which withdraws coverage or continues the coverage we now believe is in place, we will of course follow the new law. In discussing the clarity of current law, we are not urging action one way or the other on the substantive issue of coverage.

Before getting into more detail in response to the questions you asked about guaranty fund law, I want to take a moment to set the issue of guaranty fund coverage in a practical context.

We believe that the presence or absence of guaranty fund coverage for ALIAC products is, at best, only marginally significant when considering the value of any given product. ALIAC enjoys "Superior" and "Excellent" ratings from each of the four major agencies which rate

insurance companies for financial strength. Guaranty fund coverage of our products, since it only becomes an issue in the event of ALIAC's insolvency, is a remote concern.

The value of our products is a function of the financial strength of our company; our reputation in the market place; and our ability to design products which specifically address the broad ranges of financial needs and strategies of those who are saving for retirement.

The presence or absence of guaranty fund coverage for our products is even less significant from a competitive standpoint. If our products are covered, so are similar products sold by our competitors. If our products are not covered, neither are similar products sold by our competitors. Again, the points which distinguish Aetna Life Insurance and Annuity Company are financial strength; reputation; and product design. Guaranty fund coverage -- be it present or absent -- is simply not an issue for a customer choosing from an array of similar products offered by different insurance companies.

Nevertheless, you have asked for our views regarding coverage under current law and, in the interests of clarifying this issue, we respond.

THE CONTRACT

To understand whether guaranty fund coverage exists, it is first necessary to understand ALIAC's contract with the State of Kansas.

The contract (GLID-CDA-HO; a copy of which is attached as Exhibit 1) between Aetna Life Insurance and Annuity Company and the State of Kansas was effective July 1, 1980. The contract is a group annuity product.

During the accumulation period of the contract (while individuals are active employees of the State of Kansas), the State of Kansas Plan is responsible for providing Aetna with updated participant information, deposit amounts for each participant, and withdrawal instructions. The contract provides a guaranteed minimum interest rate on deposits to fixed return accounts. The actual credited rate of interest may be increased for periods of time during the term of the contract.

Aetna maintains individual accounts for each participant in the plan and the accounts are set up based on information received from the State of Kansas. Deposits are credited and tracked on an individual account level. The investment allocation of the accounts is based on instructions received from the individual participants. This participant level control was authorized by the State of Kansas Plan. The current investment options for the participants to choose from include four General Account fixed options (guaranteed rates of return), and twenty-six variable mutual fund options, ranging from a money market fund to growth and international funds.¹ The amount of investment options available to participants has grown considerably over recent years.

¹ Funds in the mutual fund accounts concededly are outside the scope of guaranty fund coverage as a "portion of a...contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder."
K.S.A. 40-3008(e)(1).

Participant accounts are valued daily by Aetna and the account information is made available to the individuals via an 800# phone service. Aetna also provides quarterly account statements mailed directly to participants in the plan as well as case level reports made available to the State of Kansas. The mailing of statements to individuals is also authorized by the Plan.

During the payout phase of the contract (which occurs when an employee terminates service with the State of Kansas), the State of Kansas is responsible for submitting annuitization instructions for each individual to Aetna. The annuity options to choose from include, lump sum, life expectancy, period certain, and many variations that take into account variables such as spousal continuation, etc. Variable and fixed annuities (and combinations of each) are available. Once instructions are received, Aetna sets up the payment stream for the individual, mails the checks directly to the individuals and handles the tax reporting for the distributions to the IRS and the individual states.

GUARANTY FUND LAW

In Kansas, as in many other states, guaranty fund coverage for a group annuity product is a function of whether the contract is classified as "unallocated" or as "allocated." Again as in most other states, the Kansas statutes creating the life and health guaranty association do not define an "allocated" contract. Instead, they define unallocated contracts, K.S.A. 40-3005 (m), and exclude them from guaranty fund coverage. K.S.A. 40-3008 (n)(7). Under this statutory scheme, therefore, an allocated contract is a group contract which is not unallocated. An allocated contract, subject to certain conditions, is covered by the guaranty fund.²

K.S.A. 40-3005 (m) defines an unallocated annuity as "any annuity contract or group annuity certificate which is not issued to and owned by an individual, except to the extent of any annuity benefits guaranteed to an individual by an insurer under such contract or certificate."

Read literally and in isolation from other provisions of the Kansas life and health guaranty association act, this definition would appear to render unallocated -- and, therefore, not covered by the guaranty fund -- not only the ALIAC contract, but any contracts (such as the ALIAC contract) issued to government entities for the benefit of government employees under Section 457 of the Internal Revenue Code.³ For tax purposes, these contracts are not issued to or owned by individuals. They are issued to and owned by government entities.

² Even for allocated contracts, the statutes contain limitations and exclusions. For example, guaranty fund payments may not exceed the underlying contract obligations and annuity benefits are capped at \$100,000 for any one life. In addition, as noted earlier, no coverage is provided for any portion of a policy or contract not guaranteed by the insurer or under which the risk is borne by the policy or contract holder.

³ Section 457 permits government employees to receive certain tax advantages from deferred compensation plans. However, in order to do so, they must not "own" the contract or an interest in the contract. If they do, their deposits may not be made on a pre-tax basis nor may they receive tax free interest on their deposits in the plan.

To preserve the tax benefits available under Section 457, the ALIAC contract funding the Deferred Compensation Program is neither issued to nor owned by an individual, nor does it guaranty annuity benefits directly to

However, K.S.A. 40-3005 (m) is not to be read in isolation from other provisions of the Kansas life and health act, K.S.A. 40-3001 et seq. Nor, by express provision of statute, is it to be read literally. Instead, K.S.A. 40-3004, provides:

This act shall be liberally construed to effect the purpose under K.S.A. 40-3002 which shall constitute an aid and guide to interpretation.

K.S.A. 40-3002, in turn, states that the purpose of the act is to protect the persons it specifies in K.S.A. 40-3003, including certificate holders under other types of group policies which are very similar to the policies in question here. These contracts are issued to schools for teachers under another provision of the Internal Revenue Code, Section 403 (b).⁴

Aetna's 403 (b) group annuity contracts and the 457 contract at issue here are identical except for the tax driven provisions relating to ownership and it would seem unlikely that a state statute dealing with broad contract characteristics would make a distinction between unallocated and allocated contracts based on federal law dealing with tax preferences.

And, of course, the Kansas life and health guaranty association act does not refer to retirement plans based on their tax status. It contains no mention of either Sections 457 or 403 (b) of the Internal Revenue Code. Instead, it groups contracts according to broad characteristics. They are either allocated or unallocated. If 403 (b) contracts are clearly allocated, there is no internal requirement of the Kansas guaranty fund act which requires some other outcome for 457 contracts.

In fact, all the internal evidence in the act, as well as the conduct of Kansas officials involved in the administration of the act, suggests that 403 (b) and 457 contracts with provisions similar to the ALIAC contract should be treated as allocated.

As noted, the act contains one definition of "unallocated contract." Therefore that term must have the same meaning with respect to each of two important guaranty fund functions. One of these functions is the payment of claims, the coverage issue presented in the Draft Report. Another is the assessment function, the method by which the funds necessary to pay claims are identified for subsequent collection.

In Kansas, assessment of member companies is made with respect to the premiums received on contracts covered by the act. "Premium," as defined in K.S.A. 40-3005 (j), does "not include any premiums on any unallocated annuity contract." (Emphasis added.) These premiums are to be reported in one of three accounts. Again, as defined by Kansas law, the annuity account specifically excludes unallocated annuities. K.S.A. 40-3006 (a)(3).

individual participants. Instead, all benefits and rights under the contract belong to the contract owner, the State of Kansas. (Contract: General Provisions, Section 3, p. 5).

⁴ Section 403 (b) of the Internal Revenue Code permits teachers to participate in group annuity contract and to obtain 457-type tax benefits (purchase with pre-tax dollars; tax free build up) while holding certificates which evidence an ownership interest in the group contract.

Therefore, if premium is to be reported in the annuity account, it must be premium received by the reporting company with respect to an allocated contract. If contracts are allocated for purposes of assessment, they must also be considered allocated for purposes of coverage. Logic impels this result and nothing in the act contradicts it.

For assessment purposes, the ALIAC contract with the State of Kansas is treated as allocated by ALIAC and by the Kansas Life and Health Insurance Guaranty Association according to a very clear mandate from national organizations which promulgate guaranty fund policy.

In 1994, to clarify the definition of unallocated contracts⁵, the National Association of Insurance Commissioners, of which Kansas is a member, adopted the following language, which was recommended to it by the National Organization of Life and Health Guaranty Associations. The language is part of an instruction used in filling out premium reports for assessment purposes, premium reports which are used by Aetna and received and relied upon by the Kansas Life and Health Guaranty Association:

Group annuities may be allocated or unallocated (the term "unallocated" is not synonymous with the term "group")...In addition to contracts under which periodic payments are being made to individuals, group annuity contracts should be considered allocated if the insurer is obligated under the contract upon the request of an individual (or his or her beneficiary) to make either partial or full cash withdrawal payments, which may be subject to plan or statutory restrictions, to the individual (or his or her beneficiary). The insurer will be considered to be obligated upon the request of an individual to make either partial or full cash withdrawal payments if withdrawals or death benefit payments are made from that participant's account maintained (by the insurer or its designee under the terms of the group annuity contract and regardless of whether such requests are submitted to the insurer directly by the individual (or his or her beneficiary) or indirectly through the plan trustee, administrator, sponsor or contractholder at the direction of the individual.

This instruction "looks through" the purely tax driven provisions of group annuity contracts to analyze in practical contract terms whether a contract provides individual benefits and therefore is allocated. The tax code distinction -- certificate/direct ownership -- gives way to the logic of identical guaranty fund treatment for similar types of products. Under this provision, whether or not a contract or certificate is issued or owned by an individual, the contract is allocated if an individual account is maintained and the individual has rights (whether exercised directly or through a sponsor) to withdrawal or death benefits based on that account.

ALIAC's contract is clearly allocated under the terms of this instruction. Prior to annuitization, ALIAC is required under the contract to maintain individual accounts. (Contract: Deposit,

⁵ The definition of unallocated contracts in the Kansas life and health guaranty fund association act is identical to the definition found in the Life and Health Insurance Guaranty Association Model Act, Section 5 (n).

Reserve and Surrender Provisions, Section 2, p. 6). In practice, participants receive statements of their accounts on a quarterly basis. These statements, as seen on Exhibit 2, reflect quarterly activity in the account, including credited deposits and interest; any withdrawals; and beginning and ending balances. The value of these accounts (the "Individual Account Reserve", Contract: Deposit, Reserve and Surrender Provisions, Section 7, p. 7) is payable as a death benefit to the participant's beneficiary (Contract: Deposit, Reserve and Surrender Provisions, Section 7, p. 8) or (possibly net of a surrender fee) to the participant as a withdrawal (Contract: Deposit, Reserve and Surrender Provisions, Section 13, p. 9).

ALIAC treats its contract with the State of Kansas Deferred Compensation Program as an allocated contract in reporting premium for assessment purposes. (Exhibit 3, Assessment Reports). Moreover, the Kansas Life and Health Guaranty Association accepts premium reports which treat Deferred Compensation Program premium as allocated and has made assessments on the basis of treating this premium as arising from allocated contracts. In the past five years, gross payments made with respect to those assessments have amounted to \$602,450.97. Net of refunds, payments totaled \$319, 947.65. (Exhibit 4).

In our view, Kansas' guaranty fund law is clear. Applying its terms, we believe that ALIAC's contract with the State of Kansas is an allocated contract. Because the contract is allocated, funds on deposit in its fixed account have insurance coverage under the Kansas life and health insurance guaranty association fund act. Were that not our belief, we would not have filed premium reports and paid assessments on that basis.

I hope that this letter is useful in responding to your questions.

Sincerely,



Timothy F. Bannon

