TESTIMONY BEFORE THE SENATE
KPERS SELECT COMMITTEE
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OVERVIEW OF CASH BALANCE PLANS

SUBMITTED BY REBECCA PROCTOR

Mr. Chairman and Members of the Committee:

As most of you know, my name is Rebecca Proctor. I am an attorney specializing in labor law and employee benefits law and served as a member of the KPERS Study Commission. I have been asked, as a member of the Study Commission, and as an attorney who practices employee benefits law, to provide a general overview of the structure and function of cash balance plans.

Cash Balance Plans are Defined Benefit Plans

Cash balance plans are defined benefit plans. However, they are generally viewed as a compromise between a traditional defined benefit plan and a defined contribution plan. With a cash balance plan, the worker is always guaranteed to receive the dollar value of contributions made on his/her behalf, plus a guaranteed annual interest crediting rate. The idea is that guaranteed interest crediting rate will be set below the plan's expected annual return, so that any lower performing years will be offset by higher performing years. So, the employee is protected from loss, but in exchange for that protection from loss accepts a lower rate of return.

For example, if a cash balance plan is incorporated into a defined benefit plan that has averaged an 8% return, the guaranteed interest crediting rate for the cash balance plan would be set below 8%. Any return earned by the plan greater than the guaranteed interest crediting rate may be either retained by the plan to improve the overall health of the plan or may be issued to plan participants as a discretionary dividend. Issuance of a discretionary dividend is usually conditional on the overall fundedness of the plan.

A note on excess interest earnings: because these funds are defined benefit plans held in a trust, they must be used exclusively for the benefit of plan participants and beneficiaries. However, interest earned over the guaranteed interest crediting rate can function to replace or offset an employer contribution, freeing up funds that the employer would otherwise have contributed to the plan. Depending on how the assumptions are set and how the market performs, a cash balance plan can be fully funded based on employee contributions and interest earnings.

At retirement, how benefits are paid depends on how the plan is designed. Plan design can allow for benefits to be paid as an annuity or as a combination of an

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annuity with some percentage of lump sum payment. For the annuity conversion, the cash balance plan will either define an annuity conversion rate or tie that rate to some other factor. The annuity conversion rate and the applicable mortality tables are used to convert the funds in the cash balance account into a lifetime monthly benefit.

As I explained when I addressed this committee regarding the cash balance component of the King Plan, because a cash balance plan is a defined benefit plan, any cash balance approach in Kansas would function as a tier 3 in the current KPERS system and would not require plan closure.

How are Cash Balance Plans Similar To/Different Than Traditional DB Plans?

Both cash balance plans and traditional DB plans offer a lifetime monthly benefit. Both cash balance plans and traditional DB plans hold money in hypothetical accounts for plan participants (in other words, although contributions made on each participant's behalf are tracked, they are pooled with other contributions and invested together. There are no individual accounts actually held in the participant's name).

The main difference between cash balance plans and traditional DB plans is in how the benefit is calculated. With a traditional DB plan, there is a set formula used to calculate the lifetime monthly benefit. With a cash balance plan, the benefit is determined based on the stated account balance.

There is also a difference in how benefits accrue. With a traditional defined benefit plan, the retirement benefit is based on a formula that usually includes a years of service component and a final average salary component. In a normal budgetary environment, employee pay increases with service, so often when a employee retires, the numbers pulled for a "high three" or a "high five" final average salary can be fifty percent or more attributable to the last five to ten years of employment. The increasing years of service plus the increasing rate of pay result in a significantly higher benefit for longer-term employees.

In a cash balance plan, because the benefit is based on the dollar value of the contributions and the interest accrued, the retirement benefit is based on the amount actually in the account, and not on any service or final salary components. Service comes into play only as it relates to how many years the employee account has received contributions and interest credits. In general, this means that a cash balance plan will provide a lower benefit than a traditional defined benefit plan to long-term employees (working thirty years of more) or employees who join state service as a second career or later in the career lifecycle. However, a cash balance plan will usually provide a higher benefit than a traditional defined benefit plan to people who join state service early in the career lifecycle and then leave to pursue other careers.

During our study commission meetings, the example was often given of teachers who begin teaching straight out of college, teach for twenty years, leave teaching to do something else, and then start drawing retirement benefits at normal retirement age. A cash balance plan would generally provide a higher benefit for this type of employee than a traditional defined benefit plan.

Finally, there is a difference in risk allocation. Pat Beckham delivered a presentation to the Study Commission addressing the basics of cash balance plans on September 22, 2011. It included a chart showing the differences in risk allocation in different plan designs. For a traditional defined benefit plan, the employer's investment risk is high, while the employee's investment risk is low. For a cash balance plan, the employer's investment risk is reduced to medium, while the employee's investment risk remains low. Because a cash balance plan is a defined benefit plan, there is still some risk to the employer but the risk is lower than with a traditional defined benefit plan.

Nebraska's Cash Balance Plans

Phyllis Chambers of NPERS provided information to the Study Commission regarding the Nebraska cash balance plans. Julian has indicated her powerpoint presentation is available to any committee members who would like to review it. I don't want to go in-depth of the Nebraska plan, because this is a general overview of cash balance plans, and the Nebraska's plan includes factors that are really plan design choices and not cash balance requirements. However, Nebraska currently runs two cash balance plans: a state plan and a county plan. Both plans were initiated in 2003; discretionary dividends were granted for participants in both plans for 2004-2008. Dividends and funding status are based on account balances and funding status as of December 31 of the previous year (so a dividend was paid for 2008 based on account balances and funding status as of December 31, 2007).

As of December 31, 2007, the state plan was 103.4% funded and the County plan was 108.1% funded. After the market crash in 2008, fundedness for both plans dropped. However, both plans have remained at healthy funding levels. As of December 31, 2010, the state plan was 93.6% funded and the county plan was 93.2% funded.

Conclusion

This completes my general overview of cash balance plans. I am happy to take any questions you may have.