LC No. _____
HB/SB _____[1]

REPORT AND RECOMMENDATION OF THE STATE ADMINISTRATION AND VETERANS' AFFAIRS INTERIM COMMITTEE (SAVA) TO THE 2013 LEGISLATURE AS OF NOVEMBER 2012[2]

Proposal No. 9
Proposing Entity: Senator Ron Arthun
Short Title: Establish a cash balance plan for new hires and allow voluntary enrollment by current public employees.

Retirement system(s) affected
PERS and TRS

Proposal summary
According to the Employee Benefit Research Institute: "A cash balance plan is a “hybrid” type of pension plan--i.e., one that takes on the characteristics of both a defined benefit plan (that pays a specified amount based on a predetermined formula) and a defined contribution plan (that provides an individual account for each participant, based only on amounts contributed or allocated to the account).

"Legally, a cash balance plan is a defined benefit plan, governed by the same rules that govern traditional defined benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA). A cash balance plan offers some of the popular advantages of a traditional plan, such as flexible employer funding and a retirement benefit that generally provides little or no investment risk for the plan participant."[3]

According to the professional *Journal of Accountancy*, "a cash balance plan looks like a defined contribution plan to the participant. A hypothetical account is maintained for each participant, the company makes annual notional contributions, and interest is credited on the account. The contribution to the account is either a flat dollar amount or a percentage of compensation. The interest credited is either a fixed rate (for example, 5%) or tied to an index, such as the 30-year

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[1] This report summarizes SAVA's recommendation to the Legislature as of November 2012. The report is not a summary of a bill, but of a retirement proposal as presented to SAVA during the interim. The specifics of the proposal summarized may have changed during the subsequent drafting and legislative processes.

[2] Report issued pursuant to 5-5-228, MCA.

[3] Danny Devine, "Cash Balance Plans Pros and Cons Outlined", Employee Benefit Research Institute, June24, 1999, at http://www.ebri.org/publications/prel/index.cfm?fa=prelDisp&content_id=422

Treasury bond rate."[4] However, the contributions are actually pooled as part of the investment fund and actual investment returns are credited to the fund and benefits are still paid out based on a defined benefit formula.

Fiscal implications

Unknown without an actuarial analysis.

Effect on other Montana retirement systems

Because the proposal covers only the two main retirement systems (TRS and PERS), there may be concerns of "inequity" with the other purely DB retirement plans. Nonetheless, arguments may also be made that the other systems are and should be designed to meet the particular needs of the employees covered in those systems.

Soundness as matter of retirement policy

The following principle adopted by SAVA on January 27, 2012, relates to this proposal:

Principle I - Pensions should provide the base of financial security in retirement.

Further analysis is needed to determine whether this proposal would provide a cash balance benefit sufficient to conform to this principle.

Comparison with other states

According to a report by the National Conference for State Legislatures, public employee retirement plans in three states recently adopted cash balance plans: Kansas, Nebraska, and Louisiana. These cash balance plans cover general classified employees and/or teachers. None cover public safety employees. Both Kansas' and Louisiana's cash balance plans established a new tier within their current defined benefit (DB) plans. Thus, Kansas and Louisiana are still able to use employer contributions to continue to pay the DB plan's overall liabilities. Nebraska's old plan was a DC plan, which does not have unfunded liabilities.

Among these three plans, employee contribution amounts range from a low of 4% of salary in Kansas for employees with less than 5 years of service, to a high of 8% in Louisiana. Employer contribution amounts range from a low of 3% of salary in Kansas for employees with less than 5 years of service to a high of 9.37% in Kansas.

Each state has a different way of calculating how additional interest or dividends are to be credited. Kansas credits employee accounts with a 5.24% interest. Nebraska credits the greater of the federal mid-term rate plus 1.5% or 5%.

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[4] Raymond D. Berry, "Plan Design in the Balance: Weighing the Pros and Cons of Cash Balance Plans", *Journal of Accountancy*, January2009. See http://www.journalofaccountancy.com/Issues/2009/Jan/PlanDesignInTheBalance.htm

With respect to funding its liabilities, Kansas is funding its unfunded liabilities by increasing employer contributions incrementally to 10.57% by FY 2017 and by adopting a cash balance plan that will lower employer contributions for new hires based on years of service. This allows more of the employer contributions to be used to fund the previously unfunded liabilities.[5]

Legal implications

This proposal does not raise any legal or contract impairment concerns as long as it applies only to new employees.

Testimony received

Proponents:

Senator Arthun testified he had been examining cash balance plans for a couple of years and had discussed the issue with legislators in Kansas. He stated that the advantages of a cash balance plan are that it allows for a smooth accrual of benefits over an employee's career, provides benefit portability, avoids the gaming found in DB plans (such as salary spiking), and offers a middle ground between a DB and DC plan because although the employer still carries the investment risk, that risk is lessened because the difference between the interest credited to the employee accounts and the actual rate of return accrues to the benefit of the pension fund to pay off unfunded liabilities and keep the system actuarially sound over the long term.

Opponents:

None.

Committee discussion

Questions and discussion related to how to set the interest amount to be credited to employee accounts. Sen. Arthun responded that he had not yet decided on what rate he would set, but he said that Kansas had set a 5.24% while Nebraska has set a cap of 5%. He indicated he desired to keep it simple and subsequently instructed staff to use a set 5% rate.

[5] National Conference of State Legislatures, "Pensions and Retirement Plan Enactments in 2012 Legislatures", August 31, 2012.