Cash Balance Pensions Plans

Balancing Strategy and Risk – Cash Balance Pensions for Today's Business



Agenda

- Cash Balance Plan Overview
- Considerations in Moving to a Cash Balance Plan
- Common Pitfalls in Maintaining a Cash Balance Plan
- Key Take-aways

Audience Question

- Who's considering cash balance?
 - Yes, we are considering cash balance
- Who's part of the NRECA retirement plans?
 - NRECA 401(k) Plan Only
 - NRECA Retirement Security Plan ("NRECA RS Plan") Only
 - Both
 - Neither

Cash Balance Plan Overview

What is a Cash Balance Plan — Basics

- Defined benefit plan vs. defined contribution plan
- A cash balance plan is a defined benefit plan that defines the benefit in terms that are more characteristic of a defined contribution plan.
- Each year employees earn a pay credit and interest credit
- Notional account balance (or hypothetical account)
- Increases and decreases in the value of the plan's investments do
 NOT directly affect the benefit amounts to be paid to participants
 - Investment risks are borne solely by the employer

Difference From Traditional Defined Benefit Plan

- Formula defines the benefit as a stated account balance
 - Easier to track "lump sum" benefit
 - Formula for a typical traditional defined benefit plan benefit defines the benefit as a monthly annuity or formula or series of monthly payments for life to begin at retirement
- Difference in Accrual Rates benefits generally accrue faster in a cash balance plan (more benefits earned during the early years of service)
 - In a traditional defined benefit plan, benefits accrue more at the end of an employee's career

Difference From Traditional Defined Benefit Plan

- Mobility employees are normally able to take their benefit with them when they leave an employer (benefits are portable and can be rolled over into another retirement plan)
 - In a typical traditional defined benefit plan, employees historically can't take the benefit with them all assets remain with the employer and, generally, employee receives no benefits until retirement
- Design may result in a less expensive program than a traditional defined benefit plan, but typically for a lower level of benefits

Difference From DC Plan/401(k) Plan

- Participation is automatic
 - In a 401(k) plan employees often must elect to participate and always make their own contributions
- Investment risk is the sole responsibility of the employer
 - In a 401(k) plan, the participant bears all investment risk

Difference From DC Plan/401(k) Plan

- Life Annuities cash balance plans are required to offer benefit in the form of lifetime annuity
- Federal Guarantee benefits provided under cash balance plan are insured by the PBGC
 - Benefits provided under 401(k) plans are not insured

Cash Balance – Pros & Cons

Pros

- Easier to understand/communicate
- Costs are more predictable than traditional defined benefit
- May be better suited for workforce demographics

Cons

- Cost may be higher than traditional defined benefit particularly for shorterterm employees
- Conversion to cash balance can be complex

Transitioning to a Cash Balance Plan

Getting There From Here

- No Pension Plan Now
 - Evaluate options and cost
 - Adopt a plan document
- Current Pension Plan
 - Evaluate options and cost
 - Amend current plan to reflect decision
 - Adopt cash balance plan or amendment

Getting There From Here

- Elements to Consider
 - Accrual Formula
 - Conversion Options (if currently sponsoring)
 - Grandfathering
 - Communications

Accrual Formula

- Pay Credits
 - May be different for different participants
 - Need to comply with non-discrimination, though...
- Interest Credits
 - Cannot exceed a "market rate" of interest
 - Safe harbors in the regulations
 - Depending on pay credit schedule, may need to have a minimum interest rate
 - Rate can impact value (and cost) of the benefit

Conversion Options

- Past Practices (Before 2006)
 - Common to convert all current traditional benefits to an "opening account balance"
 - All benefits then paid on total account balance
- Conversions after Fall 2005
 - New rules regarding post-conversion benefits
 - Severely limits past practice of using opening account balances
 - Generally benefits must now be A+B benefits

Conversion Options

- A + B Benefit Conversion
 - The "A" Benefit is the old traditional benefit formula
 - The "B" Benefit is the new cash balance benefit formula
- Example:
 - Participant accrued a \$1,000 monthly annuity at age 65
 - Beginning 1.1.2010, plan is converted to a cash balance plan
 - Participant retires on 12.31.2019 after accruing \$75,000 in cash balance benefits

Conversion Options

Old Method

- \$1,000/month traditional benefit valued at \$75,000 at conversion (using plan assumptions)
- \$75,000 opening account balance + interest credits (assume \$20,000) + \$75,000 in additional accruals = \$170,000 cash balance

• \$170,000 cash balance converted into optional forms of benefit

A + B

• \$1,000/month traditional benefit is frozen

- Account balance at retirement is \$75,000
- Each form of distribution = traditional benefit converted under old factors + \$75,000 cash balance converted to same distribution option
 - This is the minimum benefit
 - May use greater of this or old method

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Grandfathering

- All or Nothing?
 - Conversions do not have to be all or nothing affairs
 - Many plans "grandfather" participants with certain age and service
- Examples
 - Participants who have reached early retirement age/service will continue to accrue traditional benefit
 - Participants may elect between traditional and cash balance
 - Participants with ____ points (age + service) will accrue cash balance, but traditional benefit will also be adjusted for increase in final average pay

Grandfathering

- Consider Legal Constraints
 - Accrual Rules
 - Generally prevents "backloading" of benefits
 - Not applicable to governmental plans
 - Nondiscrimination
 - Cannot favor highly-compensated employees
 - Not applicable to governmental plans

Conversion Communications

- Communication
 - If changing current pension formula
 - 204(h) notice may be required
 - Generally 45 days before effective date of change
 - Even if not required
 - Robust communication may be helpful
 - Your time to show the benefit of this arrangement
 - Ok to "sell" this to employees
 - BUT don't mislead

Documentation

- Plan Provisions Required
 - Cash balance plans may now use preapproved documents
 - BUT limited ability to grandfather—so may need customized document
- Often Need to Adopt in Advance (not retroactively)
 - To avoid benefit reductions for current participants
- Invest In Getting This Right
 - Spend time ensuring the provisions are accurate
 - Have as many parties review this as possible

Questions for Audience

Question #1

 Does changing from a traditional defined benefit plan to a cash balance plan simplify the administration and auditing processes?

Answer #1

 No – essentially all of the administration processes and auditing requirements are the same for a traditional defined benefit plan and a cash balance plan.

Question #2

 Does the employer contribution due to the plan equal the sum of the pay credit and interest credit due to the plan on behalf of the employee?

Answer #2

• No – like with traditional benefit plans, the required contribution is actuarially determined and generally does not simply equal the sum of the pay and interest credits. Amount due from the employer is actuarially determined and will depend on assumptions, investment results and funded status of the Plan.

Question #3

 True or False – After changing from a traditional defined benefit plan to a cash balance plan, the Plan Sponsor no longer needs to engage an actuary.

Answer #3

• False – the Plan Sponsor of a cash balance plan <u>is</u> required to engage an actuary to determine the funded status of the plan and the funding requirements of the plan. Same requirements as a traditional defined benefit plan.

Common Pitfalls

Common Audit Issues

- Lack of controls/understanding with regards to census data
 - Plan Sponsor needs to ensure that there is a robust process in place that maintains census data in a format required by the actuary
 - It's the worst of both worlds (many requirements of a DB Plan and a DC Plan)
 - Bad data in early or lower paid years continues never rolls out of the final calculation
 - More demanding than with a 401(k) Plan
 - Need to understand:
 - What plan year data is needed (End of year vs. Beginning of year)
 - How data should be accumulated and communicated to actuary (transferred per pay period, monthly, annually, etc.)
 - What demographic information is required (DOB, Hire date, Marital Status, etc.)

Common Audit Issues - Other

- Demographic data provided to actuary was incorrect
- Incorrect compensation data provided to actuary
- Misinterpretation/calculation of eligible compensation
- Applying the wrong rate or interest credit

Unexpected Issues and Consequences

- It's Not Really an Account...
- Qualified Domestic Relations Orders
- (New) Common Errors

An Account or Not an Account?

- Confusion is Rampant
 - Cash balance account is really just an accounting entry
 - No actual account for participant
 - No segregated assets
 - No ability to direct investment assets
 - If plan terminated underfunded, "account" may be reduced

Qualified Domestic Relations Orders

- Need Specialized Attention
 - Family law bar may not be accustomed to these plans
 - May get traditional benefit order—which doesn't make sense
 - May get 401(k) "account"-based order—which also doesn't make sense
 - Invest in model orders to help participants
 - Include anything special to your plan—such as issues with grandfathering

Considering Moving Back?

- Can't just get rid of cash balance
- Protected benefit
 - Interest credits continue to accrue
 - Can't freeze these
- What about a termination?
 - Let's talk about annuity contracts...

Question for Audience

- Is adopting cash balance:
 - Easier than expected?
 - About the same?
 - More difficult than expected?

Key Take-Aways

Cash balance not for everyone

Tread carefully

Engage a village of experts