TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: Description of the Nebraska Cash Balance Plan and Its Predecessor, the Defined Contribution Plan

DATE: October 27, 2011

Overview of Nebraska Pension Coverage

In Nebraska, teachers have long been covered by a defined benefit plan. Currently, that plan determines benefits based on the high-two average salary (the average salary during the two years of highest salary) and the accrual rate per year is 2.0%. Therefore, the retiring Nebraska teacher receives a benefit of 2% of the high-two average salary for each year of service. In contrast, other Nebraska state and local employees (except for judges, State Patrol officers, governor appointees, and a few other minor groups) for many decades were covered by one or more defined contribution plans.

In recent years the Nebraska Legislature became increasingly concerned about the large gap in the value of the retirement coverage for teachers compared to that generated by Nebraska's Defined Contribution Plan. The gap was further increased when the value of Defined Contribution Plan accounts values fell sharply during market turmoil in 2001. This lead the Nebraska Legislature to develop a new plan for new state employees, called the Cash Balance Plan. The Cash Balance Plan and Defined Contribution Plan have many features in common, because the Cash Balance Plan was developed directly from the Defined Contribution Plan by making a few changes to avoid the obvious shortcomings of the Defined Contribution Plan. The new Cash Balance Plan began in 2003 and covers new state employees. When that new plan commenced in 2003 members of the Defined Contribution Plan were permitted to elect a transfer of coverage to the new plan. Those who chose to remain in the Defined Contribution Plan were given a second chance to elect coverage under the new plan in 2008.

The first key difference between the Cash Balance Plan and its predecessor is the group responsible for investment decisions. Under the Nebraska Defined Contribution Plan the member is responsible for asset allocation and all investment decisions, by selecting from investment choices offered under that plan. Review of results indicated that investment returns generated by the typical plan member trailed those of a professionally managed portfolio by significant amounts. To improve outcomes, under the Cash Balance Plan the state, through its Nebraska Investment Council, is responsible for directing the investment of assets, using investment managers retained by the Council.

The second key difference is a shift in the burden of investment risk. Under the Defined Contribution Plan the member bears all investment risk, but under the Cash Balance Plan the state bears the investment risk. Under the Cash Balance Plan the value of a member's account is not determined by market returns. Rather, the state pays a guaranteed interest rate to the account. Each year, account values are increased by an interest rate equal to the greater of 5%, or 1.5% plus the average yield on federal government securities with maturity between three and nine years. Thus, the minimum return is 5%, and it may be higher if the yield on government securities is sufficiently high.

While this system guarantees the member will never have an annual return less than 5%, the member is giving up the possibility of considerable gain to the portfolio in favorable market times. However, when conditions are favorable the State of Nebraska may share some of the upside gain with the plan members. Each year, an actuarial study of the Cash Balance Plan is performed. If the results show a deficient condition, the state is required to appropriate sufficient money to cover the indicated supplemental contribution rate. If the plan has assets in excess of liabilities, the pension board may declare that some of the excess will be shared with the plan members through additional payments (referred to as dividends) to the member accounts.

Comparison of Features: Nebraska Cash Balance Plan and the Nebraska Defined Contribution Plan

The following compares key elements of the state employee Nebraska Cash Balance Plan and the Nebraska Defined Contribution Plan. Similar plans exist for local public employees.

Nebraska Plans for State Government Employees

	Cash Balance Plan	Defined Contribution Plan
Eligible group	• State general employees who are permanent and work more than half-time. • Plan is optional for those working less than half-time. • Members also include employees originally covered by the defined contribution plan who elected to transfer to the Cash Balance Plan during elections held in 2003 and 2008.	• State general employees other than teachers hired after 1963 and before January 1, 2003, and who did not elect to transfer during 2003 or 2008 to the Cash Balance Plan.
Contributions:		
– Employee	4.8% (employees wanting to make a large contribution are authorized to open a defined contribution plan account to accept employee contribution amounts in excess of 4.8%)	4.8%
– Employer	156% of the employee contribution (4.8% x 156% = 7.49%)	156% of the employee contribution
Vesting	• Immediate vesting on employee contributions • 3-year vesting on employer contributions if member is under age 55, immediate vesting if age 55 or older	• Immediate vesting on employee contributions • 3-year vesting on employer contributions if member is under age 55, immediate vesting if age 55 or older
Salary for computing benefit	N/A	N/A
Salary	Total compensation	Total compensation
Investments		
– Responsibility for investments	State responsibility; all assets are part of a trust fund invested by investment managers retained by the Nebraska Investment Council.	Member responsibility; by selecting among available investment options.
– Return guarantee	Member's account credited with interest equal to the greater of 5% or the yield on U.S. government obligations with maturity of 3-9 years plus 1.5%.	N/A
– Optional additional allocation to account	• If annual actuarial valuation indicates a surplus, the Public Employees Retirement Board may choose to issue a dividend to member accounts. • If a contribution deficiency exists, the state must provide an appropriation to eliminate the contribution deficiency.	N/A
Retirement benefits:		
– Normal retirement age and service requirements	Age 55 or older. No specified service requirements.	Age 55 or older. No specified service requirements.
– Normal retirement age amount	Determined by account value.	Determined by account value.
– Early retirement age and service requirements	Under age 55.	Under age 55.
– Early retirement age amount	• Determined by account value if vested • Determined by account value minus employer contributions if not vested	• Determined by account value if vested • Determined by account value minus employer contributions if not vested
– Form of payment	• Annuity based on account value if vested (or eligible portion of account value if not vested) provided by state; or • Rollover to an outside retirement account; or • Rollover to the Defined Contribution Plan; or • Lump sum withdrawal; or • A combination of these options	• Annuity based on account value if vested (or eligible portion of account value if not vested) provided by state; or • Rollover to outside retirement account; or • Lump sum withdrawal; or • A combination of these options; or • Systematic withdrawal of fix amounts on a monthly, quarterly, or annual basis
– Benefit increases	2.5% annual increases if member selects state annuity and the COLA option when annuity commences (the monthly benefits are reduced to cover the cost of this option).	2.5% annual increases if member selects state annuity and the COLA option when annuity commences (the monthly benefits are reduced to cover the cost of this option).
Disability:		
– Age and service requirements	Under age 55; all vesting requirements are waived.	Under age 55; all vesting requirements are waived.
– Amount	Determined by account value.	Determined by account value.
Retirement after disability:		
– Age and service requirements	N/A	N/A

Nebraska Plans for State Government Employees

	Cash Balance Plan	Defined Contribution Plan
Death Surviving spouse optional benefit: – Age and service requirements	• Surviving spouse eligible for benefit only if named as beneficiary. • If not the sole beneficiary, the annuity described below would be prorated.	• Surviving spouse eligible for benefit only if named as beneficiary. • If not the sole beneficiary, the annuity described below would be prorated.
– Amount	100% joint and survivor annuity based on account value, or a rollover or lump sum payment.	100% joint and survivor annuity based on account value, or a rollover or lump sum payment.
– Benefit increases	2.5% annual increases if state annuity and COLA option elected and applicable reduction is taken.	2.5% annual increases if state annuity and COLA option elected and applicable reduction is taken.
Surviving dependent child benefit: – Age/service requirements	Eligible if named as beneficiary.	Eligible if named as beneficiary.
– Amount	Lump sum distribution of the applicable beneficiary's portion of the account value.	Lump sum distribution of the applicable beneficiary's portion of the account value.
– Benefit increases	N/A	N/A
Refund of contributions in death situations: – Age/service requirement if death while active	N/A	N/A
– Age/service requirement if retired or disabled	N/A	N/A
Termination: – Refund of contributions age/service requirement	N/A	N/A
Deferred benefit: – Age/service requirement		
– Amount	• Determined by account value if vested. • Determined by eligible portion of account value if not vested. • Member continues to accrue interest for accrual period and is eligible for dividends. • Distribution must commence by age 70½ .	• Determined by account value if vested. • Determined by eligible portion of account value if not vested. • Member continues to accrue investment earnings for accrual period until withdrawal of account or an annuity option is selected. • Distribution must commence by age 70½.