(2)

Testimony Submitted to the Senate KPERS Select Committee

By
Judy A. Miller, MSPA
Chief of Actuarial Issues, ASPPA

February 2, 2012

I am Judy Miller, Chief of Actuarial Issues and Director of Retirement Policy for the American Society of Pension Professionals and Actuaries ("ASPPA"). ASPPA is a national organization of more than 7,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines including consultants, administrators, actuaries, accountants, and attorneys united by a common dedication to the employer-based retirement plan system. All credentialed actuarial members of ASPPA are members of the ASPPA College of Pension Actuaries (ACOPA), which has primary responsibility for commenting on actuarial issues.

Before working for ASPPA, I had the honor of serving as Senior Benefits Advisor on the U.S. Senate Finance Committee staff from 2003 through 2007. As a result, I was in the middle of development of the legislation leading up to, and the conference negotiations that resulted in, the Pension Protection Act of 2006 (PPA). The cash balance provisions of PPA were one of the more contentious sections of that legislation. Our goal was to make it clear that "hybrid" retirement plans, such as cash balance plans, were legal, and to establish rules that provided protection from age discrimination while allowing enough flexibility to accommodate creativity in future plan design. The rules on permissible interest crediting rates for cash balance arrangements were a key component of those negotiations.

The KPERS Study Commission's Minority Report questioned the proposal's use of an interest crediting rate based on the actual investment earnings of the trust:

> "Because a cash balance plan is a defined benefit plan, the benefit that comes out at retirement is what must be known or defined (hence the reason a guaranteed interest rate must be set). If the interest or earnings to be awarded is unknown, the benefit is no longer defined. This is why any award of interest over the guaranteed rate is performed as a discretionary dividend; it simply cannot be required."

Although this statement makes perfect sense in the traditional defined benefit plan world, Congress made it clear in PPA that it just is not true for hybrid retirement plans like cash balance plans. The history of the legislation leaves no doubt that this outcome was deliberate. The

4245 North Fairfax Drive, Suite 750
Arlington, VA 22203
P 703.516.9300 • F 703.516.9308

ACOPA
ASPPA® COLLEGE OF PENSION ACTUARIES

Sn Select KPERS
Attachment 2
2-2-12

Senate version of the bill (S. 1783) that ultimately led to PPA would have required a positive interest crediting rate. However, the House bill (HR 2830) included no guarantees at all with regard to rates of return. The outcome was a compromise – a guarantee of "preservation of capital."

The preservation of capital requirement provides that "an interest credit (or equivalent amount) of less than zero shall in no event result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account." (IRC section 411(b)(5)(B)(i)(II)) Regulations make it clear that this is a cumulative requirement, not a year-by-year measurement. In other words, when an employee retires or otherwise terminates employment with a non-forfeitable benefit, the theoretical account balance on which benefits are based cannot be less than the sum of employer contribution credits.

The primary constraint Congress placed on interest credits is that the plan must "provide that any interest credit (or an equivalent amount) for any plan year shall be at a rate that is not greater than a market rate of return." (IRC section 411(b)(5)(B)(i)(I)) [i] PPA gave the Secretary of the Treasury authority to provide regulations regarding what constitutes a market rate of return, explicitly providing that this guidance should include both fixed and variable interest rates.

Although Congress made it clear that a market-based index that could produce both positive and negative values could be used for a plan's interest crediting rate, it was not clear whether or not a plan would be permitted to use the rate of return on plan assets as an interest crediting rate until proposed regulations were issued in October of 2010. According to the preamble to the proposed regulations, "the proposed regulations would permit the use of the rate of return on plan assets as a market rate of return for statutory hybrid plans generally if the plan's assets are diversified so as to minimize the volatility of returns."[ii]

The question as to whether or not KPERS can use the plan's actual rate of return as the interest crediting rate then becomes a matter of "if the plan's assets are diversified so as to minimize the volatility of returns". For this purpose, diversification is not required to be greater than that required to meet section 404(a)(1)(C) of Title I of the Employee Retirement Income Security Act of 1974. ERISA Section 404(a) is the "Prudent Man Standard of Care", and (1)(C) simply requires "diversifying the investments of the plan so as to minimize the risk of large losses, unless it is clearly prudent not to do so". This requirement is not a barrier to the use of a plan's actual rate of return as an interest crediting rate for responsibly managed pension trusts.

In conclusion, the proposal that cash balance accounts earn interest credits based on the plan's actual rate of return includes the required preservation of capital feature, so it is permissible under the rules for hybrid retirement plans laid out by Congress in PPA and interpreted in Treasury regulations.

---

[i] There was concern that the fixed rates of return credited on employee contributions in some state and municipal pension plans might exceed a market rate of return, so the PPA provision (as included in the ADEA) was amended in 2008 to permit governmental plans to credit a fixed rate of return to employee contribution accounts without regard to the market rate of return limitation.

ii 26 CFR Part 1[REG–132554–08]; RIN 1545–BI16: Additional Rules Regarding Hybrid Retirement Plans; Preamble Section III. B.,5th paragraph. The proposed regulatory language is in section 1.411(b)(5)-1(d)(5)).