Cash Balance Plans

THE NUTS AND BOLTS OF A FAST GROWING SEGMENT OF THE RETIREMENT MARKET

T. Rowe Price DC Resources

*Since 2001, cash balance plans have been one of the fastest growing segments of the retirement plan market. In fact, between 2001 and 2009, the number of active plans grew by 20% per year (compared with 3% growth per year in the 401(k) market).**

Much of this growth has been among small businesses—particularly professional services groups, including CPAs, law firms, and medical groups. And it has been aided by increased regulatory clarity surrounding implementation and administration of the plans.

So the question then becomes: How can you determine whether or not a cash balance plan might be appropriate for your clients and prospects?

In order to answer that question, you first need to familiarize yourself with the nuts and bolts: How do cash balance plans work? What are some of their defining features? How do they compare with traditional defined benefit (DB) and defined contribution (DC) plans?

HOW THEY WORK: A DB PLAN WITH DC CHARACTERISTICS

A cash balance plan is a DB plan that shares many of the characteristics of a DC plan. That is to say it provides a specific benefit at retirement for each employee, but it defines that benefit in terms of an individual account balance.

In a typical plan, a participant's account is credited each year with a pay credit and an interest credit. Depending on the plan, the way each of these is determined may vary. Pay credits are sometimes calculated as a flat dollar amount, or they may equate to a percentage of an employee's total compensation. Interest credits are typically either fixed at a certain percentage or linked to an index such as the one-year Treasury bill.

Fluctuation in the value of the plan's investments does not affect the benefit amount promised to participants; instead, the risk of losses (and the reward from gains above the interest credit) is borne entirely by the employer.

Each participant in the plan has an individual account, such as is the case in a DC plan, and receives periodic statements.

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DEFINING FEATURES: PROTECTION, PORTABILITY, AND PAYOUT OPTIONS

Protection – As with traditional DB plans, cash balance plans are backed by the Pension Benefit Guaranty Corporation (PBGC). So if a participant's employer files for bankruptcy or otherwise cannot meet its obligations, the PBGC may cover those pension payments—up to the legal limit.

Portability – In contrast to some other DB plans, cash balance plans often permit vested participants to receive their account balance as a lump sum if they leave their job before reaching full retirement age. Participants also have the ability to roll that lump sum into an individual retirement account (IRA).

Payout options – In most cash balance plans, when participants reach full retirement age and elect to begin receiving benefits, they have two options (assuming the participant's spouse consents to the choice): receive the full value of their account balance in the form of a lifetime annuity or receive a lump-sum payment.

A QUICK COMPARISON

Cash balance plans versus DC plans – Typical cash balance plans differ from DC plans in four primary ways:

	CASH BALANCE	DEFINED CONTRIBUTION
CONTRIBUTIONS	Employer contributions only	Employer and employee contributions (for 401(k) plans)
INVESTMENT RISKS	Assumed by the employer	Assumed by the employee
ANNUITIES	Required to be offered to employees	Optional feature
FEDERAL GUARANTEE BY THE PBGC	Yes	No

For more information

You can learn more about cash balance plan basics by visiting **http://www.dol.gov/ebsa/faqs/faq_consumer_cashbalanceplans.html**. You may also want to partner with other advisors or providers who have expertise in cash balance plan design and administration.

* *Kravitz, National Cash Balance Research Report, 2011.*