Is a cash balance plan right for your organization?

Since the first cash balance plan was established in 1985, many employers, both large and small, have adopted this plan design for their defined benefit plan. The cash balance plan design offers many elements of a defined contribution plan within the framework of a defined benefit plan. The decision to establish a new cash balance plan, or convert an existing plan to a cash balance plan, must be made after considering the plan's effect on both the employer and the participants. This paper provides an overview of cash balance defined benefit plans from both the employer and employee perspective.

Defining traditional defined benefit plans

Throughout this paper we use the term "traditional defined benefit plan." A traditional defined benefit plan has several common features. First, a traditional defined benefit plan typically defines the benefit in terms of a monthly income payable at a specified normal retirement age such as 65. Traditional defined benefit plans may also pay a lump sum amount, but the benefit is usually expressed in terms of a monthly income rather than in terms of a lump sum amount or cash balance. Second, the monthly income benefit is determined based on a mathematical formula that uses a participant's service, salary, or both to determine the monthly income. Third, the participant may often retire under the plan at points in time other than the normal retirement age; in these cases, there are adjustments to the benefit based on the participant's age when his/her benefits begin.

Understanding cash balance plans

A cash balance plan is a defined benefit plan that has plan feature characteristics that make it resemble a defined contribution plan, particularly from the participant's point of view. A cash balance plan provides a benefit that is communicated to participants as an account balance, even though no true account balance exists. Each participant in a cash balance plan has an account, and that account grows by compensation credits and interest credits that appear to be the same as the contributions and investment earnings of a defined contribution plan. However, in the cash balance plan, unlike the defined contribution plan, the compensation credit and the interest credit are both guaranteed.

The benefit under a cash balance plan is a guaranteed benefit, commonly expressed to employees as an account balance instead of as a guaranteed monthly benefit. Each participant's cash balance account is the sum of the compensation credits for prior plan years provided under a benefit formula that expresses the compensation credit based on age, service, a percentage of compensation, or all of these factors.

The compensation credit approach closely resembles the approach of the typical defined contribution plan. The cash balance account also receives interest credits periodically (typically based on an outside financial or investment index). These interest credits appear the same as the investment earnings of an account within a defined contribution plan, except that they are guaranteed to the participant.

The compensation credits and interest credits continue to be added to each participant's account until the participant leaves the company due to voluntary termination, disability, death, or retirement. Further, if the participant defers the payout of the cash balance benefit until a later date, the cash balance account continues to accrue regular interest credits while in the plan.

The primary cash balance formula for the plan may be supplemented by a traditional defined benefit plan formula. When there is more than one formula provided, the participant often receives the greater of the benefit determined under the cash balance formula or the traditional formula. The traditional formula is thus used to provide a guaranteed minimum benefit either permanently or during a temporary transition period.

When the participant leaves the company, the vested cash balance account is typically paid as a lump sum. However, since this is a defined benefit plan, the participant is also granted the right to annuity forms of payment which provide a guaranteed monthly benefit. The amount of the monthly benefit is determined at retirement and is related to the lump sum amount available.

Underneath the surface of a cash balance plan, there exists a true defined benefit plan. The cash balance account in the name of the participant is a "notional account" meaning that the cash

balance account is not tied to the underlying assets. In fact, the assets of the cash balance defined benefit plan equal the sum of participants' cash balances only by coincidence. An actuary is still involved to assess the funded status of the plan, and to determine appropriate contributions necessary to fund the expected future cash balance benefits payable from the plan. This means that the plan is funded like any other defined benefit plan; i.e. turnover, mortality, salary increases, and investment returns may be assumed in developing the actuarial funding requirements under ERISA. In addition, accounting expense disclosures required for most employers under FASB or GASB accounting standards are typiclally applicable. And finally, if the employer is eligible for coverage, the cash balance account benefits are guaranteed by the Pension Benefit Guaranty Corporation.

Comparing traditional defined benefit, cash balance, and defined contribution plan designs

Plan design considerations for many employers have included comparisons of their goals to defined benefit or defined contribution plan characteristics. Of course, many employers have chosen to maintain both defined benefit and defined contribution plans for their employees. The chart, featured later in this paper, provides a comparison of common traditional defined benefit, cash balance, and defined contribution plan designs.

Evaluating the cash balance design option

As a hybrid plan design that combines various defined benefit and defined contribution plan attributes, the cash balance plan represents another plan option with advantages and disadvantages which should be carefully evaluated in determining whether such a plan is appropriate for a given situation. The cash balance plan is not suitable for every employer. Several considerations from the point of view of an employer and employee are discussed below.

Employee advantages

The cash balance plan approach contains the defined contribution characteristics that many employees find attractive, however, the cash balance plan offers these additional advantages:

- Accounts earn a guaranteed rate of interest.
- Benefits provided are funded and expensed, without regard to profits, under specific guidelines of the Internal Revenue Code and pronouncements of the accounting standards boards.
- Benefits are further guaranteed by the Pension Benefit Guaranty Corporation.
- Benefits are relatively "portable" — the employee may take the lump sum and roll the balance to their new employer's plan.
- Although most benefits are taken in a lump sum, annuity options are available, sometimes at more favorable terms than are available if the employee tries to purchase an annuity on an individual basis.

Employer advantages

Despite controversy surrounding cash balance plans, employers continue to adopt or convert to a cash balance plan approach, citing the following reasons:

- To increase employee understanding and appreciation of their retirement benefits,
- To simplify communication to employees,
- To simplify retirement plan design, making benefits easier and simpler to calculate,
- To recognize changing workforce demographics and career patterns,
- To consolidate benefit programs and merge them into a unified plan design following a merger or acquisition, and
- To make costs under the defined benefit plan more predictable and therefore easier to control.

Because the accrual of benefits under a cash balance plan generally follows that of a true defined contribution plan, actuarial costs for cash balance plans tend to be much more predictable. If the contribution formula is defined as a level 4% of pay for each covered employee, actuarial funding levels and accounting expense will closely track that contribution formula. Over time, some variation in the contribution funding level will occur due to investment experience, differences in assumed rates of inflation versus actual rates, and unforeseen turnover.

Because the cash balance plan offers a guaranteed investment return to participants under the plan, the rate credited to employees' accounts is not dependent on the actual investment results of the trust fund. The sponsor of the plan is still able to pursue a long-term investment strategy for investment of fund assets. Since the investments will most likely be a combination of stocks and bonds, the long-term return of the assets may be greater than the interest amounts credited to participant accounts.

The difference between a higher actual rate of return on trust assets and the guaranteed rate of return credited to participant accounts is an actuarial gain to the plan sponsor's benefit. However, if investment results are less than the guaranteed rate of return credited to participant accounts, instead of enjoying a gain, the employer suffers a loss. The employer's loss is amortized over a fixed period of years; the number of years depends on the applicable funding requirements or the applicable accounting standards.

Employer disadvantages

The features that make this type of plan appealing to employees may make it undesirable to employers, namely:

- Like traditional defined contribution plans, cash balance plans provide much larger benefits for short-service and younger employees. In order to provide the same level of benefit at retirement as a traditional defined benefit plan, the cost to the employer will be higher for these short-service employees. The ultimate cost to the employer to sponsor a cash balance pension plan can be higher than for a traditional defined benefit plan.
- The complexity of the conversion, and its related participant education and communication process, is often underestimated by employers.
- The conversion to a cash balance pension plan from a traditional defined benefit plan formula will almost certainly create some "losers" as well as some "winners" in terms of the ultimate the participant is expecting to receive in retirement.
- Cash balance plans encourage payment of single sum distributions. Because the participant shoulders all future risks upon receiving a lump sum, this form of payment may not be optimal for maintaining an employee's standard of living in retirement. In addition, payment of single sum distributions will generally mean that plan assets are lower than if monthly benefits were paid. This means that the plan's payment of lump sums at fixed income rates precludes the gains from long-term investing in a mix of stocks and bonds, resulting in lower returns, lowers assets and higher contributions over time.
- Administration of cash balance plans is more exacting than traditional defined benefit plans, but less exacting than true defined contribution plans. (With cash balance plans, as with defined contribution plans, complete and accurate employee information is necessary in order to correctly maintain and update employee account balances. Should there be data exceptions, the employee account balance can be reconstructed through an accurate work history and knowledge of past interest rate credits.) With a cash balance plan there are no in-service withdrawals or investment options to track, and it is not necessary to reconcile account balances with trust assets.

Employee disadvantages

The transition from a traditional pension plan to a cash balance pension plan can be confusing for employees.

- Cash balance plans reflect employees' average salary over their full career with the company. Consequently, for employees with fast rising compensation (where salary increases outstrip inflation) or employees in the middle of their careers with a company, a cash balance plan is less effective than a traditional final average pay defined benefit plan.
- Because the participant shoulders all future risks upon receiving a lump sum, this form of payment may not be suitable for maintaining an employee's standard of living in retirement. An organization considering converting a traditional defined benefit plan to a cash balance plan should examine how different types of employees are affected by the change.

Deciding if a cash balance plan is right for your organization

Because cash balance plans are easier than traditional defined benefit plans for employees to understand, they have been well received by many companies. However, the cash balance approach is not appropriate for every organization. Traditional defined benefit plans favor employees who are older and who have longer service. If the employer's objectives are met by continuing to direct most of the retirement benefit dollars toward these employees, then a cash balance plan may not be the best pension plan design for the organization. If, however, the employer employs or seeks to attract younger employees, then the cash balance plan design is worth consideration.

Employer with younger, more mobile workforce

Employers who employ younger, more mobile employees may wish to consider the cash balance plan design. Under a typical traditional defined benefit plan, the present value of the benefit earned in a given year for an older employee is often many times the value of the benefit earned by a younger employee. A younger employee who terminates employment after a significant number of years of service (say 10 years of service) has "built" little value in his benefit under the traditional defined benefit plan. A cash balance plan can provide significant benefits for younger employees with this level of service. A cash balance plan in effect shifts more of overall plan benefits to younger employees with less service than under a traditional defined benefit plan. Thus, for plans of equal expense, the cash balance plan will provide lesser benefits to longer service, older employees.

Cost control

As mentioned above, the cash balance plan design over time allows more manageable, less volatile costs. In addition, when transitioning from a traditional defined benefit plan to a cash balance plan design, the plan sponsor may receive one-time gains in accounting expense due to decreases in projected level of benefits.

Acquisition tool

For acquisition-oriented companies, the uncertain liabilities associated with a traditional, defined benefit plan arise in any

acquisition of a new company or division. The actual liabilities assumed, either past or future, have to be calculated by actuarial valuation in order to be accurately assessed. Furthermore, if the acquiring company has a relatively young workforce, and the merging company has a relatively older workforce, the contribution by employee groups may be disproportionate.

With a cash balance plan, benefit costs are more age-neutral, in most designs, therefore costs may be estimated over the long-term by the plan's compensation credit formula. Employees in the merging company may be easily combined with employees of the acquiring company without significant cost variations. If the employees of the acquired company were covered by a traditional defined benefit plan, the cash balance plan can be amended to provide that the traditional benefit formula under the old plan be continued for a transition period or permanently, for those employees.

Transitioning from traditional defined benefit plan to cash balance plan

Before an employer chooses to convert its traditional defined benefit plan to a cash balance plan, the plan sponsor and its advisors should carefully examine the long-term effect on costs and benefits. The examination should include an analysis of the replacement of pre-retirement income at representative ages.

In addition, the relative merits of permissible financial indices should be evaluated to decide the interest rate to be credited to participant accounts. Other particular plan design issues, such as vesting and possible modification to various benefit entitlements, may also be explored. The following transitional plan design issues should be addressed:

- If the traditional benefit is to be converted to a lump sum beginning account balance the basis for conversion of current accrued benefits into the beginning cash balance must be defined. The actuarial basis for the conversion of existing accrued benefits is important: the lower the interest rate basis for conversion, the higher the beginning account balance.
- How to treat older employees close to normal retirement age who may be hurt by the conversion of the plan to a cash balance approach. Employees who are entering, or who are in the midst of, the greatest period of incremental growth in their benefits will suddenly have that growth become age-independent. These employees may suffer an economic loss through the conversion, unless the traditional defined benefit formula is maintained as a minimum benefit. The analysis must determine to what extent, and for how long, such a minimum is to be available to provide adequate retirement income replacement ratios under the new plan.
- The impact of the conversion on mid-career employees (such as an employee age 50 with 20 years of service). This group of employees has usually had long service under a traditional defined benefit plan formula that has not yet produced high benefit values. Converting to a cash balance pension plan means that these employees will not experience the high rate of growth in benefit that would be promised under the traditional defined benefit formula. Protecting these individuals may lead to a plan design in which contribution credit rates are varied somewhat by the age and/or service of the employee.
- The effect, if significant, of the curtailment of subsidized early retirement benefits which may have been available under the traditional defined benefit plan. Under the cash balance plan, subsidized early retirement benefits are no longer available; in other words, the cash balance benefit is an actuarially equivalent benefit replacing the subsidized benefit. Where once there may have been encouragement to retire early, there is now neither encouragement nor discouragement.

Each of these issues will require analysis of representative groups affected, discovery of the financial impact on each, and discussion of partial or total solutions based on the total retirement income package offered by the plan sponsor. Finally, several human resource factors will need to be reviewed:

- capabilities of the current human resources information system or payroll system,
- quality of human resource data, and
- capabilities needed to handle the ongoing administrative duties associated with a cash balance plan.

Implementation and communication of the cash balance plan should be deferred until recordkeeping needs are known and proper steps are taken for adequate administration.

Communicating the cash balance plan to employees

In connection with the adoption or conversion of an existing plan to a cash balance plan, company management (particularly the human resources department) must be prepared for a comprehensive communications effort with employees. Communicating a solution to employees that is understandable and concise is the next step in implementing a successful cash balance plan transition.

The first and foremost question in an employee's mind will be, "How does the change affect me?" This question must be answered by such means as personalized projection statements comparing the old plan to the new plan basis or by online calculators made available to each employee. Where expected future benefits are curtailed, participants benefit communications must meet the timing, content, and personal delivery requirements of ERISA Section 204(h). Many other questions should be anticipated and answered through explanatory materials and employee meetings.

Plan comparison

Traditional Defined Benefit versus Cash Balance versus Defined Contribution

Feature	Traditional Defined Benefit plans (DB)	Cash Balance plans (CB)	Defined Contribution plans (DC)	Advantages/disadvantages
Benefits				
Amount of benefit	Fixed (i.e., "defined"); determined from plan benefit formula; typically a function of years of service and compensation	Somewhat fixed; determined from plan accumulation formula; typically a function of compensation and investment credits; compensation credits and investment credits correlate to contributions and investment earnings in DC plans	Ultimate benefit depends on accumulation of contributions and investment earnings	• DB can be designed to provide benefits at targeted income replacement ratios • Lower paid employees do not have disposable income to save for their own benefit in DC • Significant benefits can accumulate in the early stages of a participant's career in DC
Guaranteed benefits by employer	Employer obligated to provide defined benefit	Employer obligated to provide accumulated balance of compensation and investment credits	Employer NOT obligated to provide defined benefit	• No reduction in benefits under DB if participant retires when stock market is low
Responsibility for benefits	Typically employer bears full responsibility for providing benefits	Typically employer bears full responsibility for providing benefits	Employee bears responsibility for making contributions and making investment decisions to fund benefits; employer may also contribute	• Lower paid employees may not be able to accumulate a meaningful retirement benefit in DC
Form of payment	Monthly benefits; can also offer single sum benefits	Must offer monthly benefits, but most plans also offer single sum benefits	Single sum benefits typically; can also offer monthly benefits	• DB provide life annuity payments more efficiently than CB or DC • Life annuities eliminate risk of participants outliving account balances • Many participants who receive single sum distributions spend them rather than saving them for retirement
Time for payments to commence	Typically at retirement age	Typically upon termination of employment	Typically upon termination of employment	• Participant may have to wait until normal retirement age to receive benefit from DB
Portability of benefits	None, unless single sum payment	Highly portable due to single sum payment option	Highly portable due to single sum payment option	• Single sum payment option allows employer to avoid keeping track of terminated employees until benefits are payable • Participants can roll single sum payments into plan of new employer or into IRA

Plan Comparison

Traditional Defined Benefit versus Cash Balance versus Defined Contribution

Feature	Traditional Defined Benefit plans (DB)	Cash Balance plans (CB)	Defined Contribution plans (DC)	Advantages/disadvantages
Fees and expenses (continued)				
PBGC coverage	Required for most plans	Required for most plans	Not required	• DB and CB must pay premiums to the PBGC
Miscellaneous				
Employee understanding	Low, but can be improved with regular employee communications	Better than DB, but probably less than DC	High	• CB and DC easier for employees to understand and therefore appreciate
Employees favored	Higher paid, longer service employees	Younger, shorter service employees	Younger, shorter service employees	• DB allow employer to reward longer service and higher paid employees • DB useful in the recruitment of older executives; executives hired at mid-career or later cannot accrue meaningful benefit in DC • CB and DC useful in recruitment of younger employees • CB and DC advantageous for employees who change jobs frequently • DB more advantageous for "fast-track" employees whose earnings increase more rapidly than inflation
Employer attitude	Paternalistic	Paternalistic, though not as much as traditional DB plans	Employee should bear some (or primary) responsibility for retirement benefits	
Investment risk	Employer bears risk	Employer bears risk	Employee bears risk	• DB and CB may experience higher rates of return due to employer's ability to and understanding of investing for long-term • DB and CB do not require participants to become investment experts, participants are often too conservative with their own DC investments • Employer still has fiduciary responsibility in DC with participant directed investments (e.g., soliciting or monitoring appropriate investment options)

Plan Comparison

Traditional Defined Benefit versus Cash Balance versus Defined Contribution

Feature	Traditional Defined Benefit plans (DB)	Cash Balance plans (CB)	Defined Contribution plans (DC)	Advantages/disadvantages
Miscellaneous (continued)				
Separate accounts for each employee	No	Recordkeeping accounts exist for each participant, but these accounts are not reconciled directly to assets as in DC plans	Yes	• Participants understand separate accounts better since similar to bank balance
Ability to reward prior service	Easier to recognize	Easier to recognize	Much harder to recognize and not as effective in recognition	• DB and CB advantageous if employer wishes to recognize past service • Participant's past service at plan inception generally not recognized in DC
Cost-of-living recognition	COLA increases can be provided to protect against inflation	COLA increases can be provided to protect against inflation, but ineffective if high selection of single sum payments	Cannot provide COLA increases	• DB most useful for providing inflation protection (though costly to provide) • Participant more likely to have inflation-protected benefits in DB
Early retirement incentive	Employer can easily provide subsidies to encourage early retirement generally or for select "window" period	Can employ traditional DB techniques	Difficult to provide	• DB and CB useful to employer who wishes to encourage early retirement

Additional information

This paper has presented a general overview of cash balance plan considerations. A plan design process that considers the cash balance option should carefully address employer goals and objectives and also provide meaningful analysis of the effects on participants. Once the decision is made, implementation of a cash balance plan design requires the combined efforts of qualified professionals and employer staff to successfully communicate and administer the new plan.

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