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Consultant's Corner

Cash Balance Plans Provide Practical Option for Today's Retirement Environment

By Paul Bonsee and Zorast Wadia, Milliman

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Paul Bonsee
Consultant
Milliman

Zorast Wadia
Consulting Actuary
Milliman

Consultants and advisors should have a cash balance plan in their toolkits whenever they speak to clients about how to sharpen the competitiveness of their retirement plan packages while controlling risk.

The last few years have not been good for retirement funding, with defined contribution (DC) plans seeing a decline in assets and defined benefit (DB) plans facing both the asset decline and an increase in corporate pension liabilities, creating a sizeable funding shortfall – $295 billion for the largest 100 corporate pensions as of the end of May 2010.[1]

In such an environment, few are considering new retirement vehicles – even though now is a good time to do just that. Cash balance plans are among the hybrids first created in the 1980s as a way to tap into excess assets in DB plans that could not otherwise be accessed. Cash balance plans combine key features of both DB and DC arrangements in a single vehicle – they resemble DC plans but are technically DB plans. Virtually all cash balance plans include features such as:

- (A) Opening balance: hypothetical participant accounts.
- (B) Interest credit: A defined rate of return assigned to participant accounts.
- (C) Pay credit: An annual employer contribution made to participant accounts.
- Closing balance: The ability for participants to track the growth of their account balance ((A) + (B) + (C)).

A key component of a cash balance plan is interest crediting, and the selection of a benchmark rate to be used in the process. Each year, the plan sponsor credits participants' accounts with a fixed percentage of pay, plus an interest credit tied to a certain financial performance standard.

[1] Milliman 100 Pension Funding Index, June 2010.

At the same time, cash balance plans must fully vest in three years, which means they are able to deliver the popular portability of the DC plan, a valuable feature for so many employees in today's market.

Are cash balance plans the right choice for every employer? This article considers some of the issues.

DB Plans and Hybrids: A Clarification

Let's start by looking at where cash balance plans come from. In DB plans, the plan sponsor assumes the investment risk by guaranteeing both the level of benefit and the payout period. DB plans also have the additional backing of the Pension Benefit Guaranty Corporation (PBGC). Unlike the individualized accounts found in most DC plans (like 401(k)s), DB plan assets are pooled with investment management decisions made by plan fiduciaries. This asset pooling is also efficient as the payout period for beneficiaries will vary in length. At the heart of any defined benefit plan is the benefit formula, which describes how benefits are accrued and how the value of the promised final payout is determined.

Beginning in the 1980s, as many corporations began to question the wisdom of committing to DB plans, so-called hybrid plans began to be promoted by benefit consultants. Cash balance plans – a strategy that combines the risk pooling of DB plans with the portability of DC plans – were introduced. These were adopted by a number of large and well known public corporations. During the '80s and '90s, in fact, many sponsors of traditional DB plans with "final average pay" benefit formulas converted their arrangements to cash balance plans. By 2003, nearly 2 million workers were covered by them.

But after much early fanfare and plan sponsor interest, cash balance plans hit a number of speed bumps in the '90s. Cash balance plans came under criticism as being complex. In addition, a number of early plans employed an interest rate benchmark that proved difficult to match in the financial markets. Perhaps the greatest blow to the plans was the much publicized lawsuit filed against IBM by some of its employees when IBM sought to amend its traditional DB plan to a cash balance arrangement. The pace of conversion to hybrid plans had slowed markedly by the early 2000s.

The field was prepped for cash balance plan growth in 2006, and the current environment may offer the kind of favorable conditions necessary in order for these plans to flourish.

The Cash Balance Plan Comeback

In 2006, several developments cleared the way for cash balance plans. In August of that year, the Seventh Circuit Court of Appeals overturned the Cooper v. IBM decision, dismissing the charge of age discrimination. Later that year, the Pension Protection Act (PPA) was signed into law, establishing clear guidelines for cash balance plans.[2] Since then, we have seen the emergence of a new generation of cash balance plans that credit participant accounts with a fixed percentage of pay, but employ a conservative benchmark to credit interest.

The field was prepped for cash balance plan growth in 2006, and the current environment may offer the kind of favorable conditions necessary in order for these plans to flourish. Consider these key developments:

- A national business recovery may be underway, and with it a renewed competition for talented workers at all levels and demographic profiles.
- Financial markets have rebounded from 2008 lows, but they are volatile and increasingly complex to navigate successfully.

[2] "Born again: Cash balance plans get new lease on life with latest rulings, pension reform 2006 legislation," Richard Bottelli, Jr., Benefits Quarterly, January 2007.

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- Significant numbers of DC plans have suffered reductions or eliminations of their employer matching contributions.
- Large numbers of traditional, final average pay DB plans are "frozen," that is, either closed to new participants or with benefit accruals eliminated entirely.
- Employers want to transition to a DC environment, but are concerned about significantly decreasing the benefit levels for long-service and older workers.
- Corporate management remains keenly focused on risk mitigation.
- The workforce remains traumatized by personal financial losses, especially in their DC plan individual accounts.

For employers seeking to start a new plan, a cash balance arrangement designed today could offer a 5%-of-pay employer contribution, which is similar to (or greater than) the match found in many 401(k) plans. The vesting requirement for these plans, set by the PPA, is now three years, an appealing horizon to younger employees. Employees don't have to contribute in order to receive a contribution, a plus to financially strapped employees of all ages. And, because cash balance arrangements are DB plans, participants can elect to receive their benefits as either a stream of annuity payments, or as a lump sum. For plan sponsors who suspended their 401(k) company matches and may now be in a position to resume them, they might consider channeling portions of those restarted contributions into cash balance plans.

Additional modifications that can be considered under a cash balance design include:

- Age weighting the employer's pay credit formula to steer larger benefits to older participants with longer service.
- Using Social Security integration within the benefit formula to deliver higher pay credits to participants with earnings above the taxable wage base.
- Limiting lump sum payouts to participants who have attained a specified age to inject a further dose of paternalism and reduce the risk of earlier-than-desired termination or retirement.

Conclusion

401(k) plans will likely remain a dominant retirement plan vehicle for corporations for many years to come. But, clearly, a cash balance plan can be tailored to implement a host of varied goals even as it supports the objectives of risk and volatility mitigation.

Whether a cash balance plan is the optimum choice for a specific company depends on many factors. But plan consultants and advisors would do well to fully understand the nature and potential of a cash balance plan, and to be comfortable in putting it on the table when the situation calls for it. ■

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