Cash Balance Plan Design Considerations

A powerful retirement savings strategy

Meeting The Needs Of Today's Workforce

How Does a Cash Balance Plan Work?

A cash balance plan is a hybrid defined benefit plan in that the plan combines features of both defined contribution and defined benefit plans. Similar to most defined benefit plans, there are no participant contributions in a cash balance plan. The employer determines benefit levels and bears responsibility for providing the specified level of benefits at retirement. Like a traditional defined benefit plan, funds are not segregated into individual accounts, but rather, are pooled and managed as a single trust fund.

The plan expresses benefits in terms of hypothetical account balances for each participant; in this sense, benefits are communicated to employees in much the same way as a defined contribution plan. Account balances are "hypothetical" in that, like any other defined benefit plan, the benefit must always be convertible to the underlying annuity. Annual contribution credits may be constant or may increase based on advancing age and/or service. The contributions are credited with a rate of interest that is typically tied to an outside index, such as the one-year U.S. Treasury Bill rate.

On an annual basis, participants receive a statement illustrating their account balance, which equals the lump sum value of their benefits under the plan. Statements include a beginning-of-year account balance, earnings for the year, the employer provided allocation and an end-of-year balance.

Cash Balance Plans combine features of both defined benefit and defined contribution plans

Plan Design

Benefit Philosophy

Developing an effective plan design begins with understanding an organization's business objectives and how those objectives translate into a benefits philosophy. Our consultants work with clients to address questions that lead to a clearly defined benefits philosophy. Typical questions focus on:

- Where the company attempts to position its compensation and benefits programs relative to its competitors
- How the company wants to apportion its retirement benefit dollars among various vehicles—pension, defined contribution savings and nonqualified plans
- The company's attitude toward allocating benefits based on overall company performance
- The company's view of benefits — as an entitlement vs. a form of compensation

Plan designs are then developed to ensure the overall package is consistent and in alignment with the organization's cost and benefit objectives.

Key plan design elements include:

Eligibility
Typically, minimum age and/or service with the organization is required before one becomes eligible to participate in the plan.

Plan Salary
Defines the salary (e.g., base salary, W-2) used in the benefit formula.

Benefit Formula
Defines the level of benefits provided to employees under the plan and determines the level of required employer contributions.

Payment Forms
Defines the benefit payment options available under the plan.

Interest Crediting
Defines the interest rate basis that will be used to credit plan contributions.

Vesting
Defines the number of years an employee must work before being entitled to receive a benefit under the plan.

Eligibility And Plan Salary

Eligibility

Employees are enrolled upon completion of the eligibility requirements selected by the employer. For instance, the employer may require that the employee:

- Attain age 21 and/or
- Complete a period of continuous employment of anywhere from one to twelve months.

The employer may also elect to exclude from participation certain classes of employees, provided Internal Revenue Service (IRS) minimum participation and coverage requirements can be satisfied.

Plan Salary

Plan salary is used to determine allocations under the plan. Salary may be limited to base pay, or base pay plus bonuses, overtime and commissions. It may also be expanded to include total W-2 compensation.

Cash balance plans can be designed based on an organization's unique needs.

Benefit Formulas

The plan's benefit formula is a fundamental plan design issue. The benefit formula affects both the level of retirement income that the plan will provide and the plan's overall cost. Cash balance plans provide annual salary-related credits in accordance with the plan's benefit formula.

Uniform Percentage Formulas

An employer may elect to provide employees with a uniform annual contribution of between 2% and 15% of plan salary. Contributions are posted to each participant's hypothetical account. Account balances earn a guaranteed rate of interest each year. Rather than providing a single allocation rate for all employees, rates can increase with length of service or age.

Service Graded Formulas

A service graded formula provides an annual credit which increases as a percentage of salary every five or ten years of service.

Example

1% Increase For Every Five Years Of Service

Years of Service	Percent of Plan Salary
1 – 5	3%
6 – 10	4%
11 – 15	5%
16 – 20	6%
21 – 25	7%
26 – 30	8%
31 – 35	9%
36 – 40	10%
Over 40	11%

2% Increase For Every Ten Years Of Service

Years of Service	Percent of Plan Salary
1 – 10	6%
11 – 20	8%
21 – 30	10%
31 – 40	12%
Over 40	14%

Age-graded Formulas

Alternatively, annual salary-related credits may vary based on the participant's age. An Age Graded formula provides an annual credit that increases as a percentage of plan salary once the employee reaches certain ages.

Example

1% Increase For Every Five Years Of Age

Age	Percent of Plan Salary
Up to 29	3%
30 – 34	4%
35 – 39	5%
40 – 44	6%
45 – 49	7%
50 – 54	8%
55 – 59	9%
60 and over	10%

2% Increase For Every Ten Years Of Age

Years of Service	Percent of Plan Salary
Up to 29	6%
30 – 39	8%
40 – 49	10%
50 – 59	12%
60 and over	14%

Combined Age/Service Formulas

A cash balance plan formula can be designed to provide credits based on both age and service. Under this type of arrangement, the percentage of plan salary that the participant receives as an annual credit is based on the sum (points) of the employee's age and years of service.

Example

Increments For Every Ten Years Of Age And Service
1% Initially Then 2%

Age Plus Service	Percent of Plan Salary
Less than 30	4%
30 – 39	5%
40 - 49	6%
50 – 59	7%
60 – 69	8%
70 – 79	10%
80 – 89	12%
90 – 99	14%
100 or more	16%

2% Increment For Every Ten Years Of Age And Service

Years of Service	Percent of Plan Salary
Up to 29	6%
30 – 39	8%
40 – 49	10%
50 – 59	12%
60 - 69	14%
Over 70	16%

Alternate contribution formulas are available under the program.
The above formulas are only a sample representation.

Supplemental Allocation

A cash balance plan also provides the opportunity to benefit highly compensated employees who have salary in excess of the Social Security Taxable Wage Base. Such additional contribution can be between 1-3%, in 5% increments.

Pension Equity Plan Formulas

A pension equity plan is a type of cash balance plan. Under a pension equity plan, employees accrue a percentage of final average pay (between 5-20% if a uniform % is selected) for each year worked. The percentage accrued each year may increase with age. The advantage inherent in a pension equity plan is that the benefit at retirement is reflective of final salary. As with other cash balance arrangements, the benefit is expressed in the form of a lump sum.

Sample Formula (1%/2% Formula)

Age of Employee	Percentage of Final Average Pay Accrued Annually
Under 30	4%
30 – 34	5%
35 – 39	6%
40 – 44	7%
45 – 49	8%
50 – 54	10%
55 – 59	12%
60 and after	14%

Vesting

Vesting represents the nonforfeitable right to benefits under the plan. Upon termination of employment, a vested member is entitled to a benefit from the plan, while a nonvested member is not. An employer must elect the following schedule under a cash balance plan.

Years of Service	3-Year Cliff
1	0%
2	0%
3 or more	100%

Cash balance plans offer a way to maximize benefits and tax savings.

Payment Forms

Regular Payment Form

Because a cash balance plan is a defined benefit plan, the normal form of payment must be stated in terms of an annuity. The normal form can be a Life Annuity, which provides monthly payments for the retiree's lifetime, or a Ten Year Certain & Life Annuity, which provides monthly payments for the retiree's lifetime, with guaranteed payments for the first ten years.

Optional Payment Forms

The plan also offers additional payment options. The amount payable under each of these options is adjusted to be actuarially equivalent to the regular payment form.

- Lump Sum Option
  Payment of the participant's account balance as a lump sum payment.
- 100% Joint & Survivor
  A monthly amount payable for the retiree's lifetime and the same amount continuing to the beneficiary for his or her lifetime, with guaranteed payments for ten years.
- 50% Joint & Survivor
  A monthly amount payable for the retiree's lifetime and one-half that amount continuing to the beneficiary for his or her lifetime.

Since a Cash Balance Plan is a Defined Benefit Plan, benefits are Pension Benefit Guaranty Corporation (PBGC) insured.

Funding Requirements

Interest Credits

Individual participant account balances and current year allocations are credited with a guaranteed rate of interest specified by the plan. The interest rate is usually based on a particular index, such as the Consumer Price Index or a U.S. Treasury rate. Employers select the interest rate to be credited under the plan within the guidelines issued by the IRS. One option, which can help reduce funding volatility, is to use the actual Rate of Return of plan assets during the plan year as the interest crediting rate.

Funding Methods

Employer contributions are determined using an actuarial funding method as is the case for any defined benefit plan. The funding method is used to calculate the plan's annual normal cost, which equals the value of benefits accrued under the plan during the year. The funding method takes into account expected investment earnings, projected benefit levels, employee turnover and assumptions regarding salary levels and life expectancy. It is important to note that employer contributions are not equal to the sum of the annual participant account allocations. For example, an overfunded plan may have no required employer contributions for a given year, despite the current year allocations.

Although allocations are credited to individual hypothetical accounts, actual plan assets are commingled for investment purposes. Since the plan is a defined benefit plan, participants may not direct the investment of their accounts. If the plan's investment performance exceeds the stated rate of interest, the excess will be applied to reduce the employer's cost to fund the plan. Conversely, if investments do not outperform the assumed rate, employee account balances will still receive the stated rate of return and future employer contribution requirements may increase. This is the mechanism that provides employees with benefit security by insulating them from the risk of investment losses.

Cash Balance Plan benefits are definitely determinable at any point in time.

Cash Balance vs. Traditional Defined Benefit Plans

Cash balance plans have proven to be an attractive alternative to traditional defined benefit plans for several key reasons.

- **By converting a traditional defined benefit plan to a cash balance plan, the employer avoids the need to terminate the defined benefit plan.** Plan termination typically involves extensive actuarial calculations, government filings, and the need to purchase annuities to settle plan liabilities. The process usually generates significant fees from the plan's actuary, attorney and accountant.
- **In converting a traditional defined benefit plan to a cash balance plan, very often the employer is able to reduce plan costs.** Typically, traditional plans are based on a participant's final average pay for a period just prior to retirement. Since Cash Balance benefits are based on current year's pay, plan funding requirements are generally lower. In many cases this restructuring of the benefits creates surplus assets or overfunding. This surplus can reduce or eliminate funding costs for a number of years.
- **Since cash balance benefits are expressed in the form of an account balance, employees may feel more appreciative of the contributions being made on their behalf.** The manner in which cash balance benefits can be communicated is more straightforward and makes them easier to understand than in a traditional defined benefit plan. Beyond that, interest on an account balance is guaranteed, rather than dependent on the investment performance of an actual investment fund.
- **The combination of these factors leads to greater employee understanding and appreciation of the retirement program with a lower employer cost.** The conversion of a traditional defined benefit plan is particularly advantageous where an employer maintains an overfunded defined benefit plan. The defined benefit plan can be converted to a cash balance plan, with the excess funds remaining in the plan, available to fund the cash balance benefits. The period during which the excess is expected to cover annual normal costs is extended twofold by increasing the amount of excess assets and reducing the cost of annual accruals. In underfunded plans, a more positive funded status is created with lower annual normal costs.

Transition Considerations

In the event that the employer adopts a cash balance plan in place of a traditional defined benefit plan, the plan is amended and restated to reflect the new provisions.

There are several ways to transition from a traditional defined benefit plan to a cash balance plan. Of course, all benefits accrued to the transition date are guaranteed under the prior plan provisions.

Freezing The Curent, Traditional Plan And Starting A New Cash Balance Plan

Often the best and simplest transition method is to freeze the existing plan and benefit accruals and start the Cash Balance Plan on a go forward basis. This eliminates much of the transition confusion and allows participants to see their old, traditional benefit separately.

Other transition approaches are available. However, they are generally more complex and may reduce the impact of the objective of simplifying the plan. Our consultants would be happy to discuss these alternative transition approaches with you.

To learn more about Pentegra's Cash Balance Plan solutions, contact the Pentegra Solutions Center at solutions@pentegra.com or 855-549-6689.

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