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Cash Balance Plans Growing at a Double-Digit Clip

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The hybrid pension design known as the cash balance plan is on a roll. An analysis of the most recent IRS Form 5500 filings available reveals a 17% jump in the number of cash balance plans in 2015, while 401(k) plan formation growth was a meager 3%. Is this type of plan right for your business?

Looking at the numbers

Nearly all (92%) of cash balance plans are sponsored by employers with fewer than 100 employees, according to Kravitz, Inc., a cash balance plan administrator. However, some of the country's largest corporations, including IBM, AT&T, Boeing, and FedEx, sponsor them. Overall, nearly 13 million people are covered by cash balance plans, the firm estimates.

Although there's no expectation that cash balance plans will overtake defined contribution (DC) plans in popularity, their growth is noteworthy. Cash balance plans are, technically, defined benefit (DB) plans, and represent about one-third of the DB universe. As with standard DB plans, they're covered by the Pension Benefit Guaranty Corporation (PBGC), and subject to PBGC premiums. However, if the company is a professional services firm with fewer than 26 active participants, the plan is not covered by the PBGC.

Tying in to 401(k) plans

The estimated number of cash balance plans in place in 2016 was 20,484, up from just 1,337 in 2001. Most employers offer cash balance plans in conjunction with a 401(k) plan, and not on a stand-alone basis. Many large company cash balance plans came into existence when they were converted from a standard final average pay pension.

What distinguishes them from standard DB plans is the variability of the ultimate benefit employees receive. The theoretical "account" feature resembles — but isn't technically the same — as a DC plan account.

With a cash balance plan, the employer commits to adding a fixed percentage of participants' compensation to an "account" that's, strictly speaking, more of an accounting device than an actual account as used in 401(k) plans. In addition, the sponsor credits earnings to those accounts. The interest crediting formula can be fixed, linked to an index or a combination of the two.

In recent years, regulations have given sponsors more flexibility with respect to interest crediting rates. Previously, most plans pegged their rate to rates on long-term Treasury bonds. Today, nearly as many sponsors use an "actual rate of return" crediting formula (subject to certain floors) as use the 30-year Treasury bond rate (39% vs. 44%, respectively).

Benefiting participants and sponsors

When cash benefit plan participants retire, the plan must offer them a lifetime annuity whose monthly benefits are determined by the size of the "account" balance. But vested participants also have the option of taking a lump sum distribution or IRA rollover of the accumulated "account" balance, even before retirement. Many participants see the portability feature as a big plus.

Another plus for participants is the ability to more easily understand the accrued value of their benefit, compared to a standard DB plan. Cash balance plans appeal to sponsors in that they give them a clearer view of the liabilities they're accruing over a standard DB plan. Although cash balance plan sponsors cannot back away from setting aside funds on behalf of participants as set by the plan formula, they have two fewer areas of exposure than traditional DB plan sponsors:

1. *Less vulnerable to market swings.* By linking the crediting rate on the account balance to an index, sponsors become less vulnerable to market swings. This assumes the sponsor invests plan assets consistently with the chosen index.

2. *Monthly payment set.* The size of the monthly lifetime payments at retirement is determined when the participant retires. This means, for example, that, if the cost of an annuity has risen sharply at the time a participant retires (such as because of a drop in interest rates), the sponsor isn't obliged to cover the difference between the monthly benefit that a participant might have received when annuity costs were lower, and the higher cost at the participant's retirement age. That risk is borne by the plan participant.

Looking ahead

Because you can design cash balance plans with different pay credits for distinct groups, these plans are ideal for owners wanting to make significantly higher contributions for their key executives as compared to the rest of the staff. Be sure to consult your employee benefits specialist, as the IRS rules allowing this disparity are complex.

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