ERIC

The ERISA Industry Committee

Advocating the Employee Benefits Interests of America's Largest Employers

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Understanding Cash Balance Plans

Table of Contents

I. Understanding Cash Balance And Other "Hybrid" Defined Benefit Plan Designs

The rapid emergence of new, dynamic technologies and obsolescence of many existing products and services, the need to respond to new domestic and global competitors, and the changing attitudes toward career and work by employees in many industries, requires that many employers change their incentives to attract and retain talented employees. For workers and employers in new and changing industries, and for those employees who do not anticipate a single career with one employer but who still value retirement security, the traditional defined benefit plan design has given way to cash balance and similar "hybrid" defined benefit pension plans.

The new plans are responsive to and popular with many employees: the benefits are understandable, secured by the federal Pension Benefit Guaranty Corporation (PBGC), and provide greater benefits to women and others who move in and out of the workforce. Moreover, the employer bears the risk of investment for benefits that are nevertheless portable, and employees under the new plans avoid "pension jail" and "golden handcuffs."

Recent news articles and 90-second "in depth" TV reports have failed to provide useful and balanced background material for understanding the dynamics of change in retirement security plans. Moreover, legislation based on media coverage in an effort to correct reported problems has been misdirected and overreaching.

In order to start fresh and balance the scales, The ERISA Industry Committee has prepared the accompanying materials that identify the issues in the present debate and describe why many employers have shifted from traditional defined benefit plan designs.

The ERISA Industry Committee (ERIC) is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers and is the only organization representing exclusively the employee benefits interests of major employers. ERIC's members provide comprehensive retirement, health care coverage and other economic security benefits directly to some 25 million active and retired workers and their families. The association has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

II. Cash Balance Defined Benefit Plans

Adjusting to the Realities of the Modern Workforce and the Modern Workplace

The rapid emergence of new technologies and the obsolescence of old products and services are reshaping many industries, forcing companies in those industries to adapt quickly or -- like buggy whip manufacturers in the age of internal combustion engines -- die. Businesses change their ways of doing business, move into new businesses, merge, form joint ventures, acquire other companies or are themselves acquired, and divest old lines of business or are themselves divested as they adjust to challenges and opportunities in today’s highly competitive international marketplace.

Many employees in changing industries no longer look forward to a lifetime career with one employer. They expect to change employers more frequently than their parents and grandparents did. "Get a job" has given way to "go hire yourself an employer." For those workers, a retirement plan that requires them to stay with the same company and wait for a big bump-up in the value of their pension benefits in the last few years of employment offers little incentive to join an employer recruiting for top talent.

New plan designs, such as cash balance defined benefit plans, have been embraced by employers and employees alike who need benefit plans that match the new environment in which they work.

Why Cash Balance and Similar "Hybrid" DB Plan Designs Work For Employees

Benefits are understandable: Unlike traditional defined benefit plans, cash balance plans provide an easily understood account balance for each participant. Employees – who are accustomed to dealing with bank account balances, § 401(k) account balances, and IRA balances – are comfortable with a retirement plan that provides a benefit in the form of an account balance.

Savings accrue automatically: Unlike 401(k) plans, additions are made automatically to the accounts of all employees eligible to participate in the plan. The employee does not have to choose to participate or decide how much of his or her current income to defer.

The employer bears the risk: Like traditional defined benefit plans, but unlike defined contribution plans (e.g., 401(k), money purchase plans, or profit sharing plans), the risk of investment is borne by the plan sponsor. Sudden or even prolonged downturns in the equity or bond investment markets do not affect the defined benefit promised to the participant.

Benefits are guaranteed: Like traditional defined benefit plans, but unlike defined contribution plans, benefits are insured by the Pension Benefit Guaranty Corporation (PBGC), a government agency.

Greater benefits for short service employees: An employee typically earns most of his or her benefit under a traditional defined benefit plan in the last few years before retirement. By contrast, a cash balance plan delivers benefits more evenly over the employee's career, and an employee who leaves before retirement can roll over the cash balance account to an IRA or a new employer's plan. Thus, cash balance plans are especially attractive in new industries that tend to attract highly talented, mobile workers as well as in industries that are undergoing significant changes.

Women benefit: Cash balance designs offer significant advantages to women (who are most threatened by impoverishment in old age) and others who tend to move in an out of the workforce. In fact all mobile workers -- not just women -- are more likely to accrue a significant and secure retirement benefit under cash balance plans than under many other plan designs.

Older workers benefit: The advantages of a cash balance plan design are not limited to mobile workers, however, since the value of the benefit for an older worker participating in a cash balance plan increases at the same rate both before and after normal retirement age.

Portability: Cash balance plan benefits are portable. In addition, when companies are merged, acquired, or form joint ventures, the benefits are easily transferred to a new plan. This helps employees maintain their retirement security.

Employee control: Since benefits are better understood by employees than are the benefits under many traditional defined benefit plans, employees are more likely to take responsibility for their retirement and their future, resulting in greater personal and national savings.

Getting out of "pension jail;" slipping "golden handcuffs:" Employees looking to move on to other jobs are less likely to be trapped in jobs that no longer provide challenges or advantages merely because they need to wait for the big bump-up in benefits that occurs in most traditional plans when they fulfill prescribed age and service requirements.

Annuities are available: Since annuities must be offered by a cash balance plan, participants who want to receive their retirement benefit as a stream of income avoid the increased cost and difficulty of purchasing annuities in the individual market. By contrast, if an employee who participates in a defined contribution plan wishes to receive the balance in his or her defined contribution account as an annuity, the employee must approach one or more insurance companies and purchase an annuity on whatever terms are then available to an individual purchaser in the annuity market.

A "basket of benefits": A participant's cash balance benefits are easily coordinated with the employer's "basket of benefits" as well as the individual's lifetime retirement savings that includes individual savings and investments, employer provided retirement plans, and Social Security.

Employers Also See Plan Design Advantages in Cash Balance and other Hybrid Defined Benefit Plans

A neutral impact on enterprise decisions: Because cash balance and hybrid plan designs of different companies can be coordinated relatively easily, they offer a stable "platform" to retain employees for companies engaged in mergers and acquisitions.

Appropriate employment and retirement incentives: Because cash balance plans deliver benefits evenly throughout an employee's career, they do not provide undue incentives for employees to "hang on" until reaching retirement age or to retire immediately when they do qualify for retirement.

Benefit communication to encourage saving is enhanced: Because benefits in cash balance and hybrid designs are more understandable, retirement benefits and the need to save are easier and more effectively communicated to all employees, including those who ordinarily do not pay much attention to retirement issues.

Employee recruitment is enhanced: Cash balance and other hybrid plans are an effective tool for attracting new and rewarding current employees.

Benefit coordination is enhanced: Cash balance plans readily are coordinated with the employer's savings or profit-sharing plans.

Cash Balance and Other Hybrid Defined Benefit Plans Benefit the Country as a Whole

Capital accumulation: Defined benefit plans -- which include cash balance and other hybrid designs -- have for decades been the engine of capital accumulation, making available secure sources of capital for business start-ups and economic expansion that have been responsible for the outstanding success of the American economy.

More efficient retirement savings: Because of the longer investment horizon available under defined benefit plans, the employer can invest the cash balance plan assets more aggressively and can better withstand market downturns while still providing a full benefit than can an individual participating in a defined contribution plan, who must bear investment risks alone.

Increased retirement savings: Under cash balance plans, more workers build larger savings earlier in their career, increasing their opportunity to accumulate significant retirement savings.

Increased pension participation: All eligible employees automatically accrue benefits under cash balance and other hybrid defined benefit plans. Because benefit accrual is not dependent on an employee's election to participate, more employees whose employers provide a pension plan will actually benefit from the plan.

Greater independence for women: Cash balance plans address the phenomena of the considerable number of elderly poor women with insufficient pension resources and the resulting pressure to increase targeted entitlements.

More compatible workplace for women: The design of cash balance plans can enable an employer to offer a total compensation package that provides more equal value between long service employees and women and others who tend to move in and out of the workforce.

Less pressure on government programs: By providing a reliable source of retirement income, defined benefit plans, including cash balance plans, reduce pressure on government entitlement programs for the elderly.

III. Cash Balance Glossary

Accrued benefit. An accrued benefit is the portion of an employee's normal retirement benefit that he or she has earned at a given point in his or her career.

Under a cash balance or pension equity plan, the accrued benefit is the employee's account balance. For example, an employee might receive an allocation equal to 4% of pay each year he or she works, and the employee's account might be credited with interest at 5%, compounded annually, until it is paid.

Under a traditional defined benefit plan, the accrued benefit is the amount the employee would receive as a monthly annuity for life commencing at age 65. For example, if an employee enters a final average pay plan at age 35, works until age 40, and earns average monthly pay of $1,000, that employee's accrued benefit might be $50 (1% x $1,000 x 5 years). If the same employee works until age 55 and his or her average monthly pay increases to $4,000, the accrued benefit would increase to $800 (1% x $4,000 x 20 years).

Actuarially equivalent. Benefits payable at different times or in different forms are actuarially equivalent if they are of equal value, based on certain assumptions. The plan specifies the assumptions that are used to calculate actuarially equivalent benefits. The two assumptions most often used to compare the value of one benefit to another are interest (which is used to measure the value of receiving a payment earlier instead of later) and mortality (which is used to measure the probability that the recipient will live to receive a given payment).

Cash balance plan. A cash balance plan is a defined benefit plan that defines an employee's benefit as the amount credited to an account. The account receives allocations (usually expressed as a percentage of pay) as the employee works. The account is also credited with interest adjustments until it is paid to the employee.

How is a cash balance plan different from a defined contribution plan? Like other defined benefit plans, a cash balance plan defines an employee's retirement benefit by a formula, and the employee's retirement benefit does not depend either on the employer's contributions to the plan or on the investment performance of the plan's assets, as it would in a defined contribution plan.

How is a cash balance plan different from other defined benefit plans? A cash balance plan defines an employee's benefit as the amount credited to an account, while other defined benefit plans typically define an employee’s benefit as a series of monthly payments.

Defined contribution plan. A defined contribution plan provides contributions to an individual account. The contributions are invested, and the investment gains and losses are also credited to the account. An employee is entitled to receive whatever amount is in his or her account when the employee retires. A section 401(k) plan is a type of defined contribution plan.

Defined benefit plan. A defined benefit plan provides a retirement benefit defined by a formula. An employee’s retirement benefit does not depend on the investment performance of the plan’s assets.

Early retirement benefit. If an employee retires before normal retirement age (usually 65), most defined benefit plans permit the employee to begin receiving a reduced monthly benefit at an earlier age. The early retirement benefit must be at least actuarially equivalent to the normal retirement benefit. For example, suppose that an employee has worked until age 55 and earned an accrued benefit of $800, payable as a life annuity commencing at age 65. The plan might permit the employee to retire at 55 and begin receiving an actuarially equivalent early retirement benefit of $360 commencing immediately.

Early retirement subsidy. A benefit includes a subsidy if it is more valuable than the normal retirement benefit. A benefit paid before normal retirement age is said to include an early retirement subsidy if it is greater than the actuarial equivalent of the normal retirement benefit. For example, if an employee has earned a normal retirement benefit of $800 payable as a single life annuity at age 65, an early retirement benefit of $360 at age 55 would be actuarially equivalent to his or her normal retirement benefit; an early retirement benefit of $500 at age 55 would include an early retirement subsidy, and an early retirement benefit of $800 at age 55 would be fully subsidized (that is, it would reflect no actuarial reduction for early payment).

Final average pay plan. Many traditional plans define an employee’s benefit as a percentage of average pay at the end of his or her career, when pay is usually highest. For example, an employee’s retirement benefit might be 1% of average monthly pay for the last five years of his or her employment, multiplied by his or her credited service. An employee who worked 20 years, and whose final average pay was $4,000 per month, would receive a monthly benefit of $800.

Hybrid plan. A plan that defines an employee’s accrued benefit as a single sum is sometimes called a hybrid defined benefit plan, since it combines the appearance of a defined contribution plan with the security of a defined benefit plan. A cash balance plan is one type of hybrid defined benefit plan. Another type of hybrid defined benefit plan is a pension equity plan, which accumulates pension credits and applies them to an employee's pay to calculate a single-sum benefit. For example, a participant in a pension equity plan might earn a credit of 8% for each year of service; after 20 years, he would have a single-sum benefit equal to 160% of his final average pay upon separation from service (regardless of age). There are also defined contribution plans that have the appearance of a defined benefit plan (e.g., a target benefit plan) and that may be called hybrid plans.

Are hybrid defined benefit plans subject to special legal rules? No. Hybrid defined benefit plans comply with the same legal requirements that apply to other defined benefit plans, including the rules that govern vesting, funding, and payment of benefits.

Are benefits under a hybrid defined benefit plan available as an annuity? Yes. All hybrid defined benefit plans are required by law to offer annuities. If an employee is married, a hybrid plan automatically pays the employee's retirement benefit as an annuity for the joint lives of the employee and his or her spouse, unless the employee elects another form of payment and the spouse consents.
Are benefits under a hybrid defined benefit plan federally insured? Yes. Like other defined benefit plans, hybrid defined benefit plans are insured by the Pension Benefit Guaranty Corporation. Hybrid defined benefit plans pay the same premiums to the Pension Benefit Guaranty Corporation that other defined benefit plans pay. This is another feature that distinguishes hybrid defined benefit plans from defined contribution plans (which are not federally insured).

Traditional defined benefit formula. A traditional plan defines an employee's retirement benefit as an annuity beginning at the employee's normal retirement age (usually 65) and paid monthly for his life. Most defined benefit plans provide a benefit based on the service the employee earns as a participant. The benefit payable at the employee's normal retirement age is often called the normal retirement benefit.

IV. Switching from a Traditional Plan to a Cash Balance Plan - Questions and Answers

Can an employer convert a traditional defined benefit plan to a cash balance plan? Yes. Many employers have converted traditional defined benefit plans to cash balance plans.

Do employees receive notice of the change in their benefits? Yes. If the switch to a cash balance plan significantly reduces the rate at which an employee will earn benefits in the future, the employee generally must receive a written explanation of the effect of the change at least 45 days before it takes effect; the minimum notice period is shortened for plans with fewer than 100 participants and for certain plan amendments adopted in connection with business acquisitions and dispositions. All employees also must receive a "summary of material modifications" describing their new benefits. These are the minimum legal requirements for disclosing the effects of the switch to a cash balance formula. Many employers provide much more information than the law requires about the effect of the switch on individual employees' benefits.

Do employers switch to cash balance plans for cost reasons? Most employers switch because cash balance plans better serve their business needs and their employees' retirement needs. Depending on the plan design, pension costs might fall, rise or stay about the same after a cash balance conversion. If there is a reduction in accounting costs, the reduction often results from accounting rules that tend to "front-load" more of the costs of a traditional defined benefit plan and to spread out more evenly the costs of a cash balance plan. As a result, any short-term cost reduction following the conversion to cash balance is offset by subsequent cost increases.

An employer in financial distress may change its benefit plans to reduce future costs. However, changing to a cash balance plan requires a significant commitment of company resources to ensure that the new plan design is appropriate for the company and the workforce, the transition is implemented smoothly and in accordance with the law, and employees receive appropriate information about the new plan. If an employer's objective is to save costs, it would be far simpler to achieve that goal by merely changing the formula of its traditional defined benefit plan, by terminating the plan, or by switching to a defined contribution plan.

What business or employee needs influence an employer's decision to switch? Under a traditional defined benefit plan, an employee typically earns most of his benefit in the last few years before the employee retires. A cash balance plan delivers benefits more evenly throughout an employee's career, and employees who leaves in mid-career generally can take their benefits with them. Many employers find that the more level, portable benefit provided by a cash balance plan is a better choice for workers who change jobs frequently, for workers who move in and out of the workforce (for example, while they raise families), and for businesses that are bought and sold. Employers also find that employees often appreciate a cash balance benefit more than they do a traditional benefit of equal value, since the cash balance benefit is easier to understand.

When an employer switches to a cash balance plan, what happens to the traditional benefit the employee earned before the conversion? The employer converts the employee's accrued benefit to an opening balance, making specified assumptions about future interest rates, the employee's age at retirement, and other factors. As the employee continues to work after the conversion, the employee earns pay credits and interest credits that are added to the opening balance in the employee's cash balance account.

When an employer switches to a cash balance plan, can an employee's benefit be reduced? No. An employee's benefit is protected by a legal requirement called the "anti-cutback rule." The anti-cutback rule provides that the benefit an employee receives after a plan amendment (such as a cash balance conversion) can never be less than the benefit earned immediately before the amendment. The anti-cutback rule also provides that if an amendment eliminates a benefit subsidy, an employee who qualifies for the subsidy after the amendment will still receive the subsidy on the benefit earned before the amendment

When an employer switches to a cash balance plan, will certain employees earn smaller benefits after the switch? In some cases, yes. A traditional defined benefit plan delivers most of its benefits toward the end of an employee's career. A cash balance plan tends to distribute benefits more evenly throughout an employee's career. As a result, long-service workers might earn less after the switch than they would have earned if the traditional defined benefit plan had stayed in place.

Do employers take steps to prevent the switch from hurting long-service workers? Most employers choose to adopt some form of transition benefit that maintains future benefit levels for long-service workers, at least temporarily. Some employers have allowed employees to choose one time or annually whether they wish to move to the cash balance formula or remain under the traditional formula. Other employers have provided that employees will receive the better of the traditional formula or the cash balance formula for a limited period (e.g., five years) after the switch. Keeping the employee under the traditional formula for a time is sometimes described as "grandfathering" the employee's traditional benefit.

What does "wear away" mean? Wear away occurs when a defined benefit pension plan's benefit formula is amended and the amended plan states that each participant is entitled to the *greater of* (a) the participant's benefit under the plan's old formula, calculated as of the date the plan is amended, *or* (b) the participant's benefit under the plan's new formula, based on the participant's total service (that is, based on service both before and after the date of the amendment). Under this "greater of" technique of transitioning from an old benefit formula to a new benefit formula, the benefit under the old formula is generally "frozen," or fixed, as of the amendment date and assures that each participant's accrued benefit is protected as required by ERISA's anti-cutback rule.

The "greater of" technique can result in "wear away" when a participant's "frozen" benefit under the old formula (calculated as of the date of the amendment) is initially greater than the participant's benefit under the new formula (based on total service). In these circumstances, the participant's benefit is, for some period of time, the participant's "frozen" benefit under the old formula (because it is greater than the benefit under the new formula). As the participant continues to work and earns additional benefits under the new formula, however, the participant's benefit under the new formula gradually catches up to and exceeds the benefit under the old formula. During the period between the effective date of the amendment and the date when the participant's benefit under the new formula catches up to the “frozen” benefit under the old formula, the participant does not earn any additional benefits under the plan (because the “frozen” benefit under the old formula is still the greater benefit), and the benefit under the new formula is said to “wear away” the frozen benefit under the old formula until the benefit under the new formula surpasses it and becomes the participant’s benefit. The “greater of” technique has been widely used for many years and has been approved by both Congress and the Internal Revenue Service.

The “greater of” technique is commonly used when an employer switches from a traditional defined benefit plan to a cash balance plan. Under the “greater of” approach, a participant’s lump-sum benefit under the cash balance plan may not be less than the actuarial equivalent of the participant’s accrued benefit under the old formula at the time of conversion. Likewise the participant’s annuity benefit under the cash balance plan may not be less than the participant’s accrued annuity benefit under the old formula at the time of conversion. As the cash balance benefit increases in relation to the old-formula benefit, it "wears away" the benefits calculated under the old formula.

However, because interest rates fluctuate, it is not possible to make a reliable prediction of when the cash balance benefit will exceed the benefit under the old formula. For example, when interest rates rise, the present value of the accrued benefit under the old formula might fall below the participant’s cash balance account; but if interest rates later decline, the present value of the accrued benefit under the old formula might rise above the cash balance account. Unpredictable interest rate fluctuations thus have a major impact on whether the accrued benefit under the old formula exceeds the cash balance benefit.

Wear away can also occur separately with respect to the plan’s early retirement benefit. For example, if the old benefit formula offered a fully subsidized early retirement benefit (that is, if benefits were not reduced at early retirement), a participant might initially be in wear away with respect to the early retirement benefit (because of the high subsidy), but not in wear away with respect to the normal retirement benefit.

What is "whipsaw"? When the administrator of a traditional defined benefit plan converts a participant’s monthly retirement benefit to an actuarially equivalent lump-sum benefit, the administrator must use an interest rate equal to the 30-year Treasury rate to perform the conversion. Cash balance plans are designed to offer a lump-sum distribution that is equal to the participant's account balance under the plan. In 1996, the IRS announced that it was considering issuing a proposed regulation that might require the administrator of a cash balance plan to perform an annuity-to-lump-sum conversion, even though a cash balance plan defines the benefit as a single sum to begin with. If this approach were adopted, the cash balance administrator might be required to use the plan's interest crediting rate to convert the cash balance account to an annuity, and then use the 30-year Treasury rate to convert the annuity back to a lump sum. If the cash balance interest rate is higher than the 30-year Treasury rate on the date of the conversion, the conversion would produce a lump sum larger than the cash balance account the administrator started with. This effect is sometimes called whipsaw. Even though the IRS never issued a proposed regulation mandating whipsaw, several courts have relied on the IRS's 1996 announcement to require whipsaw.

How do cash balance plans avoid the risk of being subject to a whipsaw? To avoid the risk of being required to pay a lump-sum benefit that is larger than the cash balance account, cash balance plans often limit their interest credits to a rate that will not exceed the 30-year Treasury rate.

V. The Administration's Legislative Proposals

On February 12, 2004, the Administration proposed legislation addressing three issues relating to cash balance plans: (1) age discrimination, (2) whipsaw, and (3) conversions of traditional pension plans into cash balance plans. Each of the proposals would be effective solely on a prospective basis from the date of enactment, and the Administration has proposed that the legislative history would state that there would be no inference as to the status of cash balance plans or cash balance conversions under current law.

Age discrimination. The proposal would clarify that a cash balance plan is not age discriminatory as long as it provides pay credits for older participants that are not less (as a percentage of pay) than the pay credits for younger participants. Although several courts have held that cash balance plans are not age-discriminatory under current law, one court held, in *Cooper v. IBM*, that cash balance plans are inherently age-discriminatory. In *Cooper*, the court reached the conclusion that cash balance plans are age-discriminatory because it took the pay credit that each participant earned each year and projected it with interest to normal retirement age (generally, age 65), thereby taking into account all of the interest credits that were estimated to accumulate between the current year and normal retirement age. Because the *Cooper* court took into account future interest credits in its age discrimination analysis, the projected annuity benefits of younger participants were, under the court's analysis, greater than the projected annuity benefits of older participants, since the older participants necessarily had fewer years within which to benefit from interest compounding. By contrast, the Administration's proposal focuses on the pay credits and does not convert the pay credits into normal retirement age benefits.

The Administration's proposal also would clarify that certain transition strategies used in cash balance conversions (for example, preserving the value of early retirement subsidies in cash balance accounts) are not age-discriminatory or otherwise contrary to the tax-qualification rules. Similar rules would be provided for other types of hybrid plans, such as pension equity plans.

Whipsaw. The proposal would eliminate whipsaw, thereby allowing a cash balance plan to distribute a participant's account balance as a lump-sum distribution, as long as the plan does not credit interest at a rate exceeding a market rate of return.

Cash balance conversions. Under the proposal, for each of the first five years after a conversion, the benefits earned by a current participant must be at least as valuable as the benefits that the participant would have earned if there had been no conversion, and there could be no wear-away of either normal or early retirement benefits at any time. These new requirements would be enforced by a 100% excise tax payable by the plan sponsor on any excess of the benefits required by the proposal over the benefits actually provided; however, the excise tax would not exceed the greater of (1) the value of plan's surplus assets at the time of conversion or (2) the plan sponsor's taxable income. The excise tax would not apply with respect to (a) participants who are given a choice between the plan's old formula and the new cash balance formula and (b) participants who are grandfathered under the plan's old formula.

Conforming amendments would be made to ERISA and the ADEA for statutory changes to existing age discrimination and plan distribution rules, but not for the new excise tax.