

## Green Light for Cash Balance Plans Presents an Opportunity to Conserve Cash and Lessen the Bottom-Line Impact while Maintaining or Improving Retirement Benefits

The Pension Protection Act of 2006 (PPA'06) has fundamentally changed the retirement plan landscape — not only from the point of view of new funding rules for pension plans, but also with regard to the nature and shape of capital accumulation programs that can be offered to employees. This has prompted many employers to reexamine retirement programs in the context of their employee rewards strategy and organizational objectives. As a result, employers that made design decisions before PPA'06 may now want to reconsider those choices. PPA'06 affirmed that cash balance plans are a valid defined benefit (DB) plans design that does not discriminate on the basis of age and set out ground rules for converting from a traditional DB plan.\* Recent cash balance guidance from the IRS provides additional information. (For a brief background, see the [box on page 3](#).) Cash balance plans should now be reevaluated as an alternative capital accumulation design. This *Spotlight* discusses why cash balance plans warrant reconsideration for replacement of traditional DB arrangements and as a financially attractive alternative (or supplement) to conventional defined contribution (DC) plans.

### WHAT ARE THE IMPLICATIONS?

Assuming that an employer believes that a capital accumulation arrangement is best suited for its organization, cash balance plans are being considered as the platform of choice for a number of reasons:

- They respond to employees' preference for a tangible account-based plan with portable benefits, like DC plans, plus they offer 100% protection of capital, which DC plans cannot.
- Over the long term, they may be expected to be significantly less costly from a P&L and cash basis than a look-alike DC plan.
- Although a DB plan in nature, they can be designed to effectively eliminate the "interest rate risk" of traditional DB plans that employers face under the mark-to-market concept in the PPA'06 funding rules.

### Implications for Employers with Frozen or Closed DB Plans

Under PPA'06, DB plans must achieve a funded ratio of 100% using a corporate bond-based discount rate to determine the liabilities. Consequently, as frozen or closed plans approach the 100% funded target, employers will need to decide which of two paths they will follow to avoid unintentionally building up a surplus that will have limited use.

- **The Volatility-Mitigation Path** Probably the first reaction once a plan's assets and liabilities come into balance is to take risk off the table by redirecting assets into less risky and hopefully less volatile asset classes. Unfortunately, because less risky and, therefore, less volatile assets typically are expected to have a lower investment return, this path has a significant opportunity cost.

\* A cash balance plan is an example of a hybrid plan: a DB plan that looks like a DC plan because employees' benefits "accumulate" in hypothetical "accounts" through hypothetical allocations. Employers began to shy away from offering cash balance plans in the wake of litigation that challenged the legality of cash balance plans on the grounds that, among other things, they discriminate on the basis of age. Until PPA'06, most employers had refrained from creating new cash balance plans starting in 1999, when the IRS began to rethink its original position on that design and stopped ruling on their compliance with tax-code standards. Although PPA'06 gave a green light to *new* cash balance plans prospectively as long as they meet standards laid out in the law, employers that sponsored cash balance plans prior to PPA'06 may still have some murky times ahead, as suggested by recent court decisions allowing lawsuits to proceed that allege age discrimination in a cash balance plan.

- **The Cost-Mitigation Path** In contrast to the “volatility mitigation path”, many employers will consider creating ways to use emerging excess pension assets to their financial advantage. For example, to avoid “marooning” plan assets, employers may want to consider thawing a frozen DB plan or re-opening a closed DB plan and adding a cash balance feature that can be financed by the emerging surplus. Rather than continually contributing “new cash” to a DC plan, this may be an effective way to finance employees’ capital accumulation accounts. In the longer term, this approach not only saves cash, but also puts less strain on P&L due to the arbitrage between the rate credited to employees’ accounts in the cash balance plan and the rate likely to be earned on plan assets. Simply put, a 5% DC plan will always require new cash and burden P&L with 5% of pay; but a 5% cash balance may not require any new cash, once the pension plan is generating surplus, and the burden on P&L may be less than 4% of pay — depending upon design.

Of course, this is not an all-or-nothing approach. That is, employers may wish to unfreeze or re-open the DB plan with a cash balance feature that is designed solely to draw down the expected surplus. In this case, a DC plan (in combination with the modest cash balance feature) will still be required. For example, if the goal was to provide a new 6% DC plan, the arrangement could be modified so that the DC plan provides 4% and the cash balance arrangement provides 2% — with the expectation that this 2% will be funded through the anticipated surplus in the otherwise frozen or closed DB plan.

#### Implications for Employers Considering a DB Freeze or Close

Typically, employers considering a DB freeze intend to add a DC plan or augment an existing DC plan. Until PPA’06, a DC program was the only viable capital accumulation program for those employers that sought to leave the traditional DB plan environment. Now, however, under PPA’06, employers have a choice of platforms for a capital accumulation program: a traditional DC plan and a cash balance plan. While over the long term, and depending upon the design of the cash balance plan, such a program is likely to be less burdensome from a cash and P&L point of view, this financial efficiency is not without risks. Employers in the post-PPA’06 world will need to carefully weigh which alternative is right for their situation.

#### WHAT RESPONSE, IF ANY, IS REQUIRED?

Employers considering taking advantage of the opportunities provided by cash balance plans may want to first ensure that the design aligns with their human resources and financial objectives and priorities. A cash balance plan might not be right for every organization. For example, a cash balance plan is, after all, a DB plan and employers that are primarily interested in avoiding all investment risk irrespective of the opportunity cost of doing so, or mitigating regulatory and accounting risks, might prefer using a conventional DC plan, rather than a cash balance plan, as the capital accumulation vehicle. Irrespective of approach: traditional DB, cash balance or conventional DC, it is important to note that retirement plan design must be considered in the context of an organization’s employee rewards strategy supportive of organizational objectives and competitive positioning. For example, some employers may indeed find it appropriate to consider redirecting their employee rewards strategy to provide more focus on immediate rewards in the form of incentive compensation pools to provide greater reward for those individuals, teams and/or divisions that drive better performance.



*To discuss whether a cash balance conversion would meet your company’s needs better than a conventional DC plan, contact your Segal/Sibson consultant or the nearest Segal/Sibson office from the list on the next page.*

## BACKGROUND

On December 21, 2006, the IRS issued cash balance guidance<sup>1</sup> primarily addressed to existing cash balance and hybrid plans. Of particular interest to sponsors of new cash balance plans is the safe-harbor definition of “market rate” of interest, pending further guidance:

- The long-term corporate bond interest rate used for current liability before 2008,
- The third-segment bond-related rate prescribed for plan funding under PPA’06,
- The 30-year Treasury rate currently used for lump sum conversions, or
- Any of the safe-harbor interest rates, the standard indices, with or without adjustments, described in IRS Notice 96-8<sup>2</sup> and summarized in the table below.

Standard Index	Margin
Discount rate on 3-month Treasury Bills	175 basis points
Discount rate on 6-month Treasury Bills or 12-month Treasury Bills	150 basis points
Yield on 1-year Treasury Constant Maturities	100 basis points
Yield on 2-year Treasury Constant Maturities or 3-year Treasury Constant Maturities	50 basis points
Yield on 5-year Treasury Constant Maturities or 7-year Treasury Constant Maturities	25 basis points
Yield on 10-year Treasury Constant Maturities or any longer period Treasury and Constant Maturities	0 basis points
Annual rate of change of the Consumer Price Index	3 percentage points

Under PPA’06, the interest-crediting rate under a cash balance plan cannot be higher than a market rate of interest.

(To return to the discussion of the implications, click [here](#).)

<sup>1</sup> IRS Notice 2007-6 is available on the following Web page: <http://www.irs.gov/pub/irs-tege/notice2007-6.pdf>

<sup>2</sup> IRS Notice 96-8 is at <http://ftp.irs.gov/pub/irs-irbs/irb96-06.pdf>, page 23.

## ★ SEGAL | ★ SIBSON

Atlanta	678.306.3100
Boston	617.424.7300
Calgary	403.692.2264
Chicago	312.984.8500
Cleveland	216.687.4400
Denver	303.714.9900
Hartford	860.678.3000
Houston	713.664.4654
Los Angeles	818.956.6700
Minneapolis	952.857.2480
New Orleans	504.483.0744
New York	212.251.5000
Phoenix	602.381.4000
Princeton	609.520.2700
Raleigh	919.233.1220
San Francisco	415.263.8200
Toronto	416.969.3960
Washington	202.833.6400

www.segalsibson.com