Questions and Answers on Cash Balance Pension Plans

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Employer-sponsored retirement plans have changed considerably in recent years. Cash balance pension plans are a new type of plan that has received much attention. Data from the Bureau of Labor Statistics indicate that about 23 percent of private sector workers with defined benefit pension plans had a cash balance plan in 2000; in contrast, such plans were only available to 3 percent of defined benefit participants in 1991.
Cash balance plans have features of both defined benefit and defined contribution plans, and they may be difficult to understand. What follows are a few questions and answers designed to help clarify how these new plans operate.

What Is A Cash Balance Plan?

A *cash balance plan* is a type of defined benefit plan. Like all defined benefit plans, cash balance plans guarantee a benefit amount to covered employees on the basis of a known formula. Employers bear the financial risk of cash balance plans and are required to maintain sufficient funds to pay future benefits. The unique nature of a cash balance plan is that benefits are defined as a lump sum--the "cash balance" of a covered employee’s account--rather than as a periodic payment to be received during retirement.

An employee’s balance in a cash balance plan is made up of hypothetical deposits and interest as specified in the plan’s formula. That amount is available to the employee once he or she is vested, subject to tax law restrictions. The advantage of such a plan is that the employee knows the "cash" value of the plan at any time. In actuality, the plan is funded by the employer on the basis of an annual actuarial valuation, just like all other defined benefit plans: The employer must deposit sufficient funds to allow the plan to pay future benefits.

What Methods Do Cash Balance Plans Use To Determine The Amount Credited To Each Employee?

There are several methods of crediting employer contributions to cash balance plans, including a fixed percentage of earnings and percentages that vary by age, service, or earnings. The examples that follow are typical of how plans may explain the calculation of benefit credits based on service.

Benefit Credits. On the first of January following each year of credited service, the employee will receive a benefit credit for the preceding year. Benefit credits are a percentage of pay that is determined by years of service, as shown in the following example:

Years of service	Percentage of pay
Less than 5	2
5 to 9	4
10 to 14	6
15 to 19	8
20 and above	10

Under an age-plus-service plan, the percentage of pay is based on the sum of age plus service, as in this example:

Age plus years of service	Percentage of pay

Less than 30	5
30 to 39	6
40 to 44	7
45 to 49	8
50 to 54	9
55 to 59	10
60 to 64	11
65 to 69	12
70 to 74	13
75 to 79	14
80 or more	15

Individual accounts are also credited with interest, which is often determined by the interest rates of certain U.S. securities. The interest is usually received on the accumulated balance of the account at the end of the year. This might be explained in terms of *annual interest credits*, where the employee receives interest credits on December 31 of each year. Interest is credited not only on the benefit credit received on January 1 of that year, but also on all benefit and interest credits accumulated during earlier years.

Do Cash Balance Plans Specify A Retirement Age?

By their very nature, cash balance plans are guided by two opposing principles. First, they are defined benefit plans and thus by law must specify a normal retirement age and make benefits available in the form of an annuity. In fact, the automatic form of payment for a married employee must be a joint-and-survivor annuity. On the other hand, vested participants in cash balance plans are entitled to access to their account balance in a lump sum at any time, regardless of the "normal" retirement age. This is one of the appeals of such plans.

How Do Cash Balance Plans Reconcile These Opposing Provisions?

Typically, such plans specify a retirement age for both early and normal retirement, but also offer other forms of payment, including lump sums, which employees may choose (with, in the case of married employees, appropriate spousal consent). The retirement ages may only apply to benefits taken in the form of an annuity.

For example, a plan may specify age 55 for early retirement and age 65 for normal retirement. Such retirement ages are typically only applicable to benefits received in the form of an annuity. Periodic annuity payments are calculated on the basis of life expectancy, so someone retiring at age 55 and expected to live 30 years will receive a smaller annual annuity than someone with the same cash balance retiring at age 65 and expected to live 20 years.

When a retirement plan allows a vested participant access to their account balance at any time, particularly before the early retirement age, it is not typically referred to as retirement or even early retirement. Cash balance plans may allow such vested participants to receive either a lump sum or an annuity. However, if a vested participant has a small, accumulated balance, he or she will most likely have to accept the balance as a lump sum. Workers who take such lump sums can maintain their pension benefit and avoid tax penalties by transferring funds into an Individual Retirement Account.

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