MEKETA

Cash Balance Comeback?

WHITEPAPER
APRIL 2024

CONTRIBUTORS
JONATHAN CAMP ASA, FCA
GORDON LATTER FSA, FCIA
RAFI ZAMAN CFA

Key takeaways

- **Hybrid Retirement Plan** A cash balance pension plan is viewed as a hybrid between a traditional defined benefit plan and a defined contribution plan, accrued as an individual account balance but offering annuities.
- **Employer Benefits** In the event a frozen pension plan has excess assets, adding a cash balance provision could be a capital efficient way of providing a retirement benefit to plan participants.
- **Investment Strategy** Plan sponsors should consider investments that align with the growth of the plan's account balances, considering the pay and interest credits.

Introduction

There has been recent news of a plan sponsor announcing a new cash balance provision for their active employees. This bucks the trend of the last few decades when it was common for companies to announce pension plan closures and freezing future benefit accruals. This has resulted in many companies asking the following questions:

- What is a cash balance pension plan?
- Why would a plan sponsor have interest in implementing a new cash balance provision in the existing defined benefit plan?
- Should other companies with frozen pension plans consider this approach?
- What are some investment considerations for any cash balance pension plan?

What is a cash balance pension plan?

A cash balance pension plan is viewed as a hybrid between a defined benefit pension plan that offers employees annuities and a defined contribution plan where the employee accumulates an individual **account balance**. Like a defined contribution benefit, a cash balance plan accumulates an account balance as a result of two growth mechanisms: the pay credit and the interest credit.

The **pay credit** is the benefit earned by an employee and is added to the participant's account balance as the benefit is accrued. The pay credit can be a flat amount or a percentage of an employee's salary. In some instances, the pay credit will be relatively larger for older employees, as contribution limits increase with age.

EXAMPLE A

Prior year Salary	=	$100,000
Pay Credit	=	5%
Prior year Pay Credit	=	$5,000

©2024 MEKETA INVESTMENT GROUP

The **interest credit** determines how much the account balance grows every year from an investment standpoint. The interest credit is often tied to a market return benchmark but can otherwise be a flat rate. When tied to a market return benchmark, the interest crediting rate will have a floor to ensure the participant's account balance is continuing to grow. The provisions that construct the cash balance plan's interest crediting rate are very important when considering the plan's investment strategy, as detailed later in this piece.

Based on Example A, it may appear a cash balance plan has more in common with a defined contribution plan than a traditional defined benefit plan. With regards to a defined contribution plan, the pay credit would be synonymous with the employee contribution and employer match. The interest credit would be synonymous with the return on investments the participant receives. The key differences are as follows:

- → A cash balance plan covers all eligible employees, unlike most defined contribution plans that require an eligible employee to make the election to defer part of their salary (or default enrollment) to the DC plan to earn the employer match.
- → The interest earned in a cash balance plan is not expected to fluctuate dramatically from year-to-year, for better or worse.
- → Unlike a defined contribution plan, the employer assumes the investment risk. This is why cash balance plans are categorized as defined benefit plans under ERISA.

The pay and interest credits are plan design features that are perceived to be easy for a participant to understand, which adds to the appeal of cash balance pension plans. Traditional defined benefit pension plans do not have the pay credit and interest credit structure. However, cash balance plans are like traditional defined benefit plans in several ways that are attractive to plan participants.

- → **Participation** Defined benefit plans of all kinds, traditional or cash balance, cover every employee that meets participation requirements (generally based on length of employment). They don't require eligible employees to take any action, it is done for them.
- → **Investment risks** Defined contribution and defined benefit plans both contain investment risks. The difference between the two is which party assumes the investment risk – the employee or the employer. For defined contribution plans, the employee bears the investment risks. Within defined benefit plans, the employer bears the investment risks. Within a cash balance plan, the employer is subject to the risk of fluctuations to the interest crediting rate (unless the rate is flat) and the investment risks of the assets invested in the plan's trust.
- → **Pension Benefit Guarantee Corporation (PBGC) Coverage** PBGC guarantees a certain level of coverage to all participants of pension plans in the event the plan sponsor fails to meet their obligations. To support this coverage, plan sponsors are required to fund the PBGC through annual premiums.

EXAMPLE A (cont.)

Beginning of Year Account Balance	=	$10,000
December 10-Year Treasury Yields	=	4%
Interest Credit	=	$400
Prior year Pay Credit	=	$5,000
End of Year Balance	=	$15,400

©2024 MEKETA INVESTMENT GROUP

Why would a plan sponsor have interest in implementing a cash balance plan?

- **Capital/tax efficiency** Cash balance plans allow employers to contribute tax-deductible funds to employees' accounts. These contributions grow tax-deferred until retirement. For the employer, this can be a tax-efficient way to provide retirement benefits. For plan sponsors of frozen pension plans with surplus assets[1], a cash balance provision can allocate excess assets to provide a participant benefit instead of taking excess assets as company income. Without a qualified replacement plan, taking pension assets as company income can be subject to excise, state and federal taxes.[2]
- **Employee retention and attraction** Offering a cash balance plan can be an attractive benefit for employees. It provides a predictable retirement income, which can enhance employee satisfaction and retention.
- **Supplementing 401(k) plans** Employers often use cash balance plans alongside 401(k) plans. While 401(k) plans allow employees to contribute, cash balance plans provide additional employer-funded benefits. This combination may help to create a more comprehensive retirement package.
- **Portability** When employees change jobs, they can roll over their cash balance account into an IRA or another qualified plan. This portability makes it an attractive option for mobile workforces.
- **Legal compliance** Cash balance plans comply with federal regulations (such as ERISA) and provide a clear framework for retirement benefits.

[1] Surplus assets refers to the assets held in the trust in excess of the liabilities calculated by the actuary.

[2] This statement is not intended to be tax advice. Any plan sponsor considering taking excess assets from a pension plan should first consult with their qualified tax advisors

Investment considerations for plan sponsors of cash balance pension plans?

When thinking about investment considerations, what may be a good approach is one that identifies assets that grow in a similar way as the cash balance plan's account balances. As described above, the account balances will grow with a pay credit and an interest credit, and both should be looked at separately when strategizing.

Pay credits accumulate when employees earn years of service. Therefore, pay credits will be positive and relatively predictable. Plan sponsors may look at the pay credit as an amount that should be backed by annual contributions to the plan, not an amount that should be substituted by taking a level of investment risk that may result in more contribution volatility for the plan.

The interest crediting rate is an important plan-specific factor to consider when designing an asset allocation meant to hedge liability risks. When interest crediting rates are based on market return benchmarks, it would seem logical that the plan sponsor could use certain investments to hedge future liability increases due to fluctuating interest crediting rates. However, many commonly used investments will have pros and cons, with none serving as the perfect solutions.

©2024 MEKETA INVESTMENT GROUP

Below we discuss three sample investments to illustrate the possible trade-offs while using Treasury bonds as the crediting rate.

US Treasuries In Example A, we set up a cash balance plan that credits interest for the upcoming calendar year based on the yield of the 10-year Treasury bond at year-end. Hence it may seem logical to invest in 10-year Treasury notes. While this asset mitigates the expected growth of the account balance, the value of the assets will not necessarily track the value of the liability. This is because interest rates may change during the year, thus affecting the price of the assets. Using our example, if $10,000 in the trust were invested in 10-year Treasury notes, the value is going to be roughly $10,400 at year end if 10-year Treasury interest rates started at 4% and averaged 4% throughout the entire calendar year. Any fluctuations in interest rates between purchase of the asset and payment of the interest credit will cause a change in the price of the investment. Therefore, the value of the assets could exceed or be less than those of the liability.

Cash or money market funds Investing in cash or money market funds has the opposite problem of US Treasury bonds. Cash is anticipated to increase in value regardless of the changes in interest rates throughout the year. However, cash and money market funds, in normal conditions, are anticipated to have lower yields than longer duration bonds.[3] As of March 31, 2024, the yield curve was inverted, and lower duration investments were yielding more than 10-year US Treasuries. This makes cash, at least for the time being, an attractive investment for hedging the interest crediting for a plan that is based on 10-year Treasury yields. However, in a more typical environment, cash would offer a lower yield and fall short of the gain in the liability.

[3] We define "normal conditions" as when the market offers lower rates for shorter duration assets (i.e., a normally shaped yield curve).

High yield bonds Anecdotally, we have observed some plan sponsors using high yield bonds as a cash balance plan investment. In general, this investment reduces growth risk and increases value risk (i.e., it increases the potential mismatch between the asset and the liability). High yield bonds are likely to command a higher yield than a 10-year Treasury, which gives the investor a cushion to offset value decreases. In environments where the value of high yield bonds increase, high yield bonds will be a beneficial investment for a cash balance plan. However, this asset class has shown times in the past where returns are very negative, typically times when equity markets are down. Such shortfalls create funding deficiencies and potential funding requirements.

Note that using different crediting rates can also change the relative pros and cons. Plans with a flat interest crediting rate, or ones where market rates are below the interest crediting floor, will not have the same growth risk as the scenarios above. This can create less risk or more risk in different environments.

For example, from a design perspective, cash is the safest crediting rate for the plan sponsor because it is the most predictable, easily investable, and minimizes contribution volatility. However, in many environments, cash is probably the option that is least appealing to plan participants as it usually offers the lowest level of growth and lead to periods with little to no growth, like the last decade.

©2024 MEKETA INVESTMENT GROUP

Summary

Although many plan sponsors have elected to close or freeze defined benefit pension plans over the last two decades, pensions as a form of retirement remain a capital efficient way to create retirement security for a company's employees. Creating a new cash balance provision within the construct of a frozen pension plan may be a great way to "kill two birds with one stone" where 100% of the excess assets are used and employees receive a retirement benefit. Careful consideration of plan-specific factors is extremely important when creating an investment strategy for cash balance plans.

©2024 MEKETA INVESTMENT GROUP

Disclaimers

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided "as is," without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special or consequential, which arise out of the use of this presentation.

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results.

©2024 MEKETA INVESTMENT GROUP