FINANCIAL PLANNING
PERSPECTIVES

# WHAT YOU SHOULD KNOW ABOUT CASH BALANCE RETIREMENT PLANS

You may never have heard of a "cash balance" pension plan. Or you've heard of it but don't know much about it. Retirement experts suggest that you better learn fast, particularly if you work for a

large employer with a traditional defined benefit pension plan. Experts expect cash balance plans to replace the majority of these plans within the next decade or two. Experts also say that the change may be good for young, mobile workers—but not so good for older workers caught in the transition or people who plan to work for the same company for 30 years.

A cash balance plan is a defined-benefit pension plan with features similar to defined contribution plans like a 401(k). Like a traditional pension plan, the company funds the pension, controls the investments, bears the risks and guarantees a benefit payout at retirement. However, like a defined contribution plan, the employer contributes based on a percentage of salary, and the plan sets up a hypothetical "account" for each worker that shows how much has accumulated in the worker's pension account at any given time.

Employees like this arrangement, say companies, because workers complain that they never know how much they have under traditional pension plans. But the differences between a cash balance pension plan and a traditional pension plan is more than just a matter of being able to look through a window at an account. There are important differences in how cash balance plans calculate their benefits.

In a traditional pension plan, a typical formula multiplies the years of service times a percentage of pay earned in the last few years of work. This formula favors employees who stick with a company for a long time, when pay is much higher in their latter years, versus employees who don't stay as long.

Under a cash balance plan, the company annually credits to your pension account a set percentage of your pay, say five percent. Some plans may pay a flat dollar amount, but that's less common. In addition, the account is guaranteed to earn a specified minimum interest rate. The rate might be a set rate or one tied to an index such as the Consumer Price Index or the going rate for three-month U.S. Treasury bills (recently around 4.5 percent). The interest credit typically will vary from year

to year. Obviously the amount the company contributes will increase as your pay increases over the years, but unlike a traditional pension plan, there's no heavy backloading, where you might
earn half your pension in the last few years. At retirement, you receive either a lump sum or a guaranteed annuitized payout.

Vested employees leaving the company typically are more able to roll their credited amount in a cash balance plan into an IRA. This portability and the relatively even-handed contribution and crediting by the employer, makes cash balance plans appealing to workers who change jobs several times in a lifetime. The Employee Benefit Research Institute estimates that the plan favors workers who stay less than 15 years. Workers who stay at least 25 years would fare better under a traditional plan.

Long-term employees caught in the middle of a conversion from a traditional pension plan to a cash balance plan, which many large employers are doing today, may be worse off than before, according to experts. For example, let's say the present value of your current pension plan is $50,000, but the company has decided to convert to a cash balance plan. If you leave, you can take $50,000 with you as a lump sum payout. However, if you stay, your new cash balance account might be credited with only $35,000 or $40,000, and it could be several years under the new plan before you catch up to the level of your old one.

Not all conversions work this way. Some grandfather older employees under the outgoing traditional plan, or credit older workers with a higher percentage of their pay than younger workers. The important point is, if you are joining a company with a cash balance plan, or your current employer plans to switch to one, determine how you'll fare by talking to your benefits specialist and your Certified Financial Planner practitioner.

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