WHAT ARE CASH BALANCE RETIREMENT PLANS?

Cash Balance Retirement Plans are a unique subset of retirement plans. Considered Defined Benefit plans, they are hybrids with both defined benefit and defined contribution plan characteristics. Cash Balance Retirement plans are of greatest appeal to companies with predictable cash flows and their workers, especially those with high incomes whose savings goals may not be met with traditional 401K plans.

Many companies with good cash flow have started cash balance pension plans rather than continue to contribute to a traditional defined benefit annuity plans that may have underfunding liabilities of indefinite proportions and timeframe. The required earnings rate on the cash balance plan assets are usually tied to a relatively low benchmark, with a treasury bond being common. In recent years, the law has expanded to allow "market rate" cash balance plans, and Northern Trust's Foundation & Institutional Advisors practice (FIA) has seen much interest from closely held private companies, such as law firms, accounting and consulting firms and private equity companies in these types of plans. Like all defined benefit plans, any funding shortfall is the liability of the sponsoring firm, but that liability is merely the contributions made plus the earnings accrual at the plan rate (or market rate, if so structured), and not an undeterminable open ended annuity stream. The formula for calculating the benefit includes both "pay credits" and "interest credits." Most plans are required to offer an annuity option, so it may not be possible to completely avoid that.

Within FIA, the interest we see is limited to plans with investment pools that are overseen by an Investment Committee of the firm, and invested in a manner to provide conservative long term returns over time on behalf of the participant group. The crucial component of these types of plans is that the organization is responsible for any liabilities resulting from a shortfall between the accrued benefit and the asset values. Thus a partner/owner, when seeing a plan deficit, feels as though that shortfall is exactly the same as a direct reduction of their equity capital account!

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WHAT ARE THE BENEFITS OF CASH BALANCE PLANS?

1. Cash balance plans have defined benefit style contributions, but each participant has an account balance like defined contribution plans.

2. Benefits to plan participants include transparency, portability, and potentially higher contribution limits.

3. Since the assets are managed in a single investment pool like a defined benefit plan, the investment committee makes asset allocation and risk profile decisions on behalf of the pool.

WHAT SHOULD BE CONSIDERED BEFORE ADOPTING A CASH BALANCE PLAN?

Although the use of a cash balance plan is not limited to partnerships and privately held companies, their costs and visibility can limit their practical application for many participants. Total expenses of cash balance plans are not limited to investment advisory fees. Audit, legal, government filing fees, insurance costs and the cost of individual plan accounting add to the cost of maintaining these types of plans.

Although each participant may receive a statement showing his or her individual balance, assets cannot be managed based upon the individual circumstances of the participant. The decisions made by Investment Committee may not align with the individual personal financial plans of the participant.

THE CHARACTERISTICS AND USAGE

The overwhelming majority of experiences encountered by FIA related to cash balance plans are for Limited Liability Partnerships (LLP). Often limited to a selected class (such as equity partners), the characteristics of plans we see are very high income earners who cannot come near their retirement planning goals through traditional savings vehicles, while the firm wants an additional compensation vehicle for employees. Sometimes thought of as supercharged retirement plans, the firms' maximum contribution is limited by age – but can be nearly 10 times the allowable 401k limits. The maximum 401k contribution in 2019 (excluding profit sharing) is $19,000 annually for those under age 50, and $25,000 for those over 50. Cash balance plan limits are $200,000 at age 60 and max at $225,000 at 65.

WHAT IS THE STRUCTURE OF MARKET RATE CASH BALANCE PLANS?

While the law allows for many additional types of plan structures, the one seen within FIA tend to be plans of a firm with very high earning people who are looking to augment their retirement savings beyond traditional 401k and profit sharing contributions. It also provides some tax relief to the Firm, by reducing taxable income. Market rate plans are restricted to annual earning accruals between 0% and 7% net of expenses (plans have significant costs beyond the investment advisor). Cumulative earnings losses cost the partners the amount needed to make whole any partner who withdraws their balance, while over-earning can result in contribution restrictions and increased taxable income to the partners (a problem most of us would love to have). The early years of the plan are particularly sensitive to being in a negative cumulative earnings position.

FIA'S STRENGTH IN ADVISING CASH BALANCE PLANS AT PROFESSIONAL ORGANIZATIONS

With high level professional organizations, FIA has many strengths in assisting the investment committee manage the cash balance plan. Three key topics that are frequently explored by the committee and the advisor are: appropriate risk structure, determining the best mean point for a diverse group of participants, and helping the participants understand where the plan fits in their personal financial plan.

In a law firm, the investment committee is usually comprised of the firm's ERISA lawyers and human resources representatives. The risk discussion is very different than a long term defined benefit plan, or other perpetual capital. The risks are "asymmetric," meaning avoiding losses (i. e. partner capital needed to pay distributions), especially in the early years, is far more important than maximizing returns. Second, the time frame is shorter than most FIA clients. Often the bulk of the assets are for the most senior people closest to retirement. A severe market downturn is far more painful to them than portfolios with longer time horizons.

Perhaps the biggest issue Investment Committees grapple with is the diverse makeup of the participants. The pool often ranges from thirty-somethings with huge future potential, to 70 and even 80 year old emeritus staff. There is an extended bell shaped curve of the desired aggressiveness of the younger people, and the capital preservation wishes of the oldest in the group. The Committee is forced to make a near fiduciary like decision on the best interests of the group overall. In short, the plan sponsor runs the risk some of the participants will be unhappy. One consolation is that participants over age 62 can withdraw their balances and roll them into an IRA while still employed and participating.

Another frequent issue management of these firms deal with, where FIA can help is getting the plan participants to understand the place this cash balance plan has within their total financial picture. For most, this is one piece of a bigger puzzle that might include partner capital, retirement plans, profit sharing plans, taxable investments and personal assets. This piece is meant to be among the more conservative, more stable parts of the total financial plan. If the individual wishes to have a more aggressive growth posture, they should have ample opportunity within their 401k plan, their taxable assets as well as personal assets to succeed with their goals.

This is but a brief introduction to the type of cash balance plans FIA sees, almost exclusively with professional services firms. As with any government sponsored and monitored program, there are great complexities and nuances that are involved. Hopefully this gives some insight to what Northern Trust sees with its cash balance plan clients.