Independent Actuaries, Inc.

How to Take Full Advantage of a Cash Balance Plan Interest Crediting Rate

It is not intuitively obvious to potential participants that a 4% interest crediting rate in a cash balance plan today is an attractive retirement planning option. Only after the cash balance plan is considered as part of an overall retirement planning investment portfolio does a fixed or variable interest crediting approach (as opposed to a market rate approach) in a cash balance plan start to make good financial sense.

Unlike a typical 401(k) plan, the investment return credited to an individual's cash balance plan account is not subject to individual investment discretion. The crediting rate in a cash balance plan is specified in the plan document. In essence, it is guaranteed by the plan sponsor. Regardless of the rate of return actually earned on the assets in a cash balance plan, participants are credited with the specified rate.

The investment return crediting rate can be a fixed or variable interest rate – e.g., 4% or the 30-year treasury rate plus 0.5% – or a market rate such as the return on an S&P 500 index fund. The applicable IRS regulations specify a number of acceptable variations of these two fundamental approaches.

There are advantages and disadvantages to both approaches. Unfortunately, the advantages to the participants often result in disadvantages to the employer sponsoring the plan. For example, participants naturally prefer a 7% interest crediting rate over a 4% crediting rate, but since the sponsoring employer bears the financial risk if the plan assets earn less than 7%, the employer may not be willing to commit to 7%.

Similarly, crediting a market rate such as the return on an S&P 500 fund is attractive to participants for a lot of reasons, not the least of which is the upside investment potential for those who believe stock market returns will outpace fixed income rates by enough to justify the greater risk. Nonetheless, there are administrative and regulatory difficulties that, in our opinion, make stock market based crediting rate unattractive for many employers. For example, for a multiple owner partnership like a medical or legal practice, a good cash balance plan design typically involves satisfying an intricate nondiscrimination test each year. With a market rate approach, the testing is tied to the *actual* rate of return of the market rate index in the prior year. If the S&P is up 15% one year and down 11% the next, the nondiscrimination testing becomes totally unpredictable, resulting in widely fluctuating partner contributions from year to year.

There are creative plan design features such as a minimum and/or maximum crediting rate that can reduce (but not eliminate) the unpredictability, but these kinds of features come with their own sets of problems. For example, setting minimum and/or maximum crediting rate limitations around the S&P 500 rate will make contributions more predictable, but how does a plan sponsor deal with a 3% cumulative minimum crediting rate when its underlying investments in an S&P 500 index fund decrease by 11% in one year?

503.520.0848
info@indact.com
www.independentactuaries.com

4500 Kruse Way
Suite 200
Lake Oswego, OR 97035

Independent Actuaries, Inc.

Occasionally when we work with a large professional practice that is considering adding a cash balance plan to supplement the savings available through their 401(k) plan, we hear the following comment from one or more partners: "Why should I want to participate in a cash balance plan that only credits 4% when I can earn 10% on my own by investing in the stock market?" The short answer is that a prudent investment strategy would have you invest in both. It is not an either/or question.

Fixed or Variable Interest Crediting

It is our opinion that until the risks and uncertainties associated with the stock market rate based crediting approach change – if they ever do – a fixed or variable interest crediting approach is the better alternative for the majority of cash balance plan sponsors. And, perhaps surprisingly to some, it is our opinion that for most cash balance plan participants, the fixed or variable percentage crediting rate is a more appropriate and attractive investment opportunity than the market rate approach. Here is why:

1. One of the fundamental principles of prudent investing is diversification. Someone saving for retirement should include a diversified mix of equity, fixed income, and other investments in his or her retirement savings portfolio. Utilizing the cash balance plan as the fixed income component of a retirement savings portfolio is consistent with the guaranteed nature of the crediting in the cash balance plan. There is no such guarantee available in a 401(k) plan.

2. A logical approach to diversification for someone with an existing 401(k) plan would be to more heavily weight their allocation toward equities in the 401(k) plan such that when the 401(k) plan and the cash balance plan are looked at as one portfolio, they achieve the desired split between fixed income and equity investment.

   For example, someone with a 75% equities, 25% fixed income allocation in their 401(k) account might want to change their 401(k) plan allocation to 100% equities once they start accumulating fixed income monies in the cash balance plan. Someone else might decide to leave their 401(k) investment allocation unchanged which would mean as they approach retirement they are gradually increasing their overall fixed income allocation, reducing their exposure to stock market volatility.

3. In general, financial advisors recommend increasing the fixed income portion of your retirement savings as you approach retirement. Target Maturity funds have become a tremendously popular investment choice for 401(k) plan participants because each fund is invested in a diversified portfolio of fixed income, equity, and other investments that over time as the participant approaches retirement is automatically rebalanced to weight more heavily in fixed income investments. A partner who contributes significant amounts to a cash balance plan as he or she nears retirement is in effect accomplishing the same strategy, adding to the assurance adequate savings will be available when they are ready to retire.

503.520.0848
info@indact.com
www.independentactuaries.com

4500 Kruse Way
Suite 200
Lake Oswego, OR 97035

Independent Actuaries, Inc.

4. A fixed income investment does not necessarily mean a fixed *interest rate* investment. The interest crediting rate in a cash balance plan can be a variable rate. Interest rates are at historical lows, so today's interest crediting rate might be lower than it will be down the road. If, for example, the crediting rate is the 30-year T-bill rate plus 0.5%, the crediting rate in a cash balance plan would have been about 4.5% in 1960, 8.5% in 1980 and 6.5% in 2000. Today it would be about 4.5%.

5. Upon retirement or other distributable event, a participant can roll his or her cash balance plan funds into an IRA and again self-direct the investment of those funds as he or she deems fit. The cash balance plan funds are not locked in forever in a fixed income type investment.

   Alternatively, for participants looking for stability of income when they retire, it may be possible to leave their cash balance funds largely intact, taking only periodic distributions from the plan rather than a single lump sum withdrawal. This assures the retiree of a relatively safe, steady rate of return on this portion of their retirement savings versus having to worry about the impact of up and down stock market returns on their financial security.

Market Rate Crediting

The principle attraction of the market rate crediting approach is the upside potential. Under a market rate approach, the interest credit each year can be tied to some form of stock market index. For example, the index might be the Vanguard S&P 500 Index Fund, or Fidelity Magellan Fund or even a customized fund created specifically for the cash balance plan.

From the viewpoint of a participant who prefers the long-term potential of the stock market over the more predictable returns available under the fixed or variable interest rate approach, there is not a lot of downside to the market rate approach. I can still adjust the allocation in my 401(k) plan to shift the allocation between fixed income and equity alternatives to reflect my personal risk tolerance. The regulations governing cash balance plans stipulate that in no event can the cumulative interest credits to my cash balance account be less than zero. Thus, my downside is a cumulative 0% rate of return, not negative. Perhaps the only participant-related downside affects partners whose cash balance plan benefits are at or near the maximum permitted under IRC 415. High crediting rates can result in significantly lower contributions than anticipated, even zero future contributions in some years.

For the plan sponsor, the issues are more problematic. As mentioned earlier, using a market rate crediting approach can complicate nondiscrimination testing. That in turn can result in fluctuating contribution amounts from year to year, which is especially hard on a partnership where contributions for each partner are effectively charged to that partner. For example, the plan may have been set up where I, as a partner, anticipated my share of the contribution would be $125,000 per year. If the plan were to utilize a market rate crediting approach which produced 10%, 0% and 22% interest credits in successive years, my actual contribution may vary from $125,000 to $140,000 to $70,000 in those years. How do we as partners adjust for that kind of fluctuation from year-to-year?

503.520.0848
info@indact.com
www.independentactuaries.com

4500 Kruse Way
Suite 200
Lake Oswego, OR 97035

Independent Actuaries, Inc.

A Hybrid Crediting Rate Approach

An approach used by one of our clients to mitigate the kind of contribution fluctuation risk described above was to develop a conservative portfolio, weighted heavily toward fixed income investments, but with some stock market exposure/upside potential. Their plan provides a crediting rate equal to the actual return earned by the portfolio, subject to a maximum crediting of 5.5%. Thus, this approach is technically a market rate approach since the crediting rate is the actual rate earned, not a specified rate. However, the portfolio might have as little as 10% stock market exposure, so it is fundamentally a fixed income crediting rate with correspondingly lower expected rate fluctuations.

An analysis of what the crediting rates would have been had the conservative portfolio been in place over the past 15 years indicates it would have yielded an average annual return in the 4.0% to 5.5% range most years, with only one year, 2008, that would have a crediting rate of less than 2.9%.

This approach attempts to capture the attractive features of both a variable interest and a stock market based crediting approach. From the perspective of the participants, the rate has some upside potential tied to the stock market, and the portion of the rate determined by the fixed income portion of the portfolio will vary up and down to reflect general interest rate movements. As a result, participants should expect crediting rates that are superior to a fixed income only portfolio, albeit the rate is capped at 5.5%. And, as noted earlier, in no event will the participant get a distribution that reflects less than a 0% cumulative crediting rate.

From the plan sponsor's perspective, the underlying portfolio should have much less volatility than a pure stock market based rate, providing more assurance that contributions will not fluctuate wildly due to IRC 415 and 401(a)(4) testing at very high or very low rates. Also, because the crediting rate varies with the performance of the underlying portfolio, there is virtually no risk the fund will underperform compared to the crediting rate (e.g., a plan with a 4.0% fixed crediting rate earning only 1.0% in a given year).

It is worth noting that this hybrid approach works well for our client in part because it is a relatively large plan that easily complies with the relevant compliance tests. . For a smaller employer that's pushing the envelope on 415 limits, non-discrimination testing, or minimum participation, even the small fluctuations in interest crediting anticipated under this approach could cause compliance problems.

Conclusion

When the Internal Revenue Service released its guidance on interest crediting rates for cash balance plans on October 18, 2010, there was a lot of initial buzz about the potential to use a market rate approach that had the assurance of complying with the applicable governmental regulations. What we have noticed is that in spite of the initial excitement about using a market rate approach that offers participants stock market type returns, more conservative approaches continue to be favored. What we think more likely to occur is that as the cash balance plan marketplace continues to mature, more innovative approaches such as the hybrid approach described above may become the norm.

This article was written by Alan J. Stonewall, FSPA, EA, MAAA. Mr. Stonewall is a former president of the American Society of Pension Professionals & Actuaries and former chairman and board member of the Actuarial Standards Board.

503.520.0848
info@indact.com
www.independentactuaries.com

4500 Kruse Way
Suite 200
Lake Oswego, OR 97035