limestone

Important Information Regarding Cash Balance Plan Investing

Investment market volatility makes it very important to have an understanding of the core Cash Balance Plan concepts.

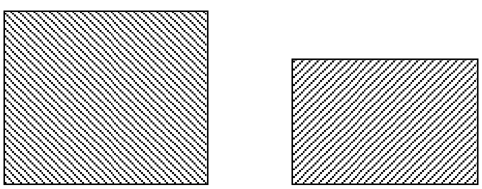
DEFINED BENEFIT PLANS

A Cash Balance plan is a type of defined benefit plan. By their terms, these plans guarantee a benefit at retirement based upon a formula stated in the plan and those benefits grow over time at a stated earnings crediting rate. This contrasts them from defined contribution plans (ie: 401(k) plans) that provide for only a stated annual contribution amount. *It is the responsibility of the employer to ensure that a cash balance plan has sufficient assets to pay out the benefits that have accrued under the plan at any given point in time.* All defined benefit plans are invested in common by the employer and the employer bears the market risk exclusively.

FUNDING vs. BENEFIT ACCRUAL

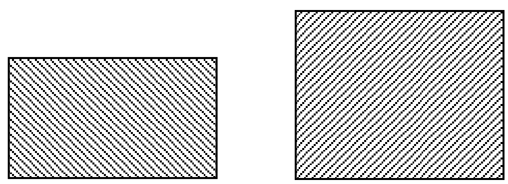
Conceptually, there are two “accounts” under a cash balance plan. The “benefit liability account” that keeps track of the benefits that have accrued under the plan each year on behalf of the plan participants and the “investment account” that represents the assets of the plan. It is very important to maintain balance between these two accounts over time.

Example 1 – Under-funding



Benefit Liability Investments

Example 2 – Over-funding



Benefit Liability Investments

OVER-FUNDING vs. UNDER-FUNDING

Both over and under-funding can cause unique plan issues. If a plan becomes over-funded, then that can result in future contributions being reduced, thus lowering the deductible deposits that can be/need to be made. While this may be a nice problem to have, it can disrupt expectations for tax-deductions. Under-funding causes the reverse and more difficult problem. Plans that are under-funded will require larger contribution deposits than anticipated and can also cause significant restrictions on plan operations.

DEPOSIT FLEXIBILITY

The amount of the annual deposit is primarily driven by the benefit formula in the plan and then is adjusted according to the funding status as mentioned above. Use of actuarial assumptions can provide some level of flexibility with annual contribution deposits. In addition, future benefit accruals can be adjusted by amending the plan formula or even freezing it altogether. However, freezing/adjusting future accruals does NOT prevent the earnings crediting that occurs with respect to benefits already accrued by plan participants. In other words, there is some flexibility, but not as much as with defined contribution plans.

INVESTMENT OBJECTIVES

The investment of cash balance plan contributions is the responsibility of the plan Trustees in conjunction with the advice of their investment advisor. Because of the implications of under and over-funding, many advisors choose to invest the assets in such a way that investment returns will closely match the plan’s earnings crediting rate while assuming as little risk as possible. Most plan earnings crediting rates are around 5%.

RECOMMENDATION

Cash Balance sponsors need to be prepared for higher or lower deposit requirements due to market conditions. To minimize the impact of market conditions, you should consult with your investment advisor with respect to most effectively maintaining the funding balance of your plan.

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