Agenda

1. Cash Balance Overview
2. New Regulations
   - Interest Crediting Rates
   - Preservation of Capital Rule
3. Issues
   - Compliance Testing
   - Lump Sum Payments
4. ICR Changes
5. Coming Soon

New Rules: October 19, 2010

- Final Regulations
  ✓ Effective immediately
- Newly Proposed Regulations
  ✓ Effective January 1, 2012
  ✓ Can rely on them now
First, the Good News...

- IRS thumbs up for Cash Balance Plans
- More ICR options
- Some funding issues minimized

...But Proceed With Caution

- New options = new challenges
- More IRS guidance pending
- Seek expert advice before changing ICR

Cash Balance Overview

- Defined Contribution
- Cash Balance
- Defined Benefit

- 401(k)
- Profit Sharing
- Hybrid
- Traditional
Cash Balance Accounts

- Participants have accounts
- Accounts grow in 2 ways:
  1. Employer Contribution
  2. Interest Crediting Rate (ICR)

Cash Balance ICR Options

"Cash Balance 1.0" – prior to New Regulations:
- ICR cannot exceed "Market Rate of Return"
- IRS did not clearly define "Market Rate"
- Plan sponsors relied on safe harbor rates

Safe Harbor Rates

- Yield on 30-year or shorter Treasury bonds
- Interest rate on long-term investment grade corporate bonds
- Other rates listed on our website
- Ranged from 1.23% - 5.20% as of 10/31/2010
Cash Balance 1.0 Funding Issue

Return on Investments > ICR
- Earnings ↑...next year’s contribution ↓

Return on Investments < ICR
- Earnings ↓...next year’s contribution ↑

2010 Rules Changed the Game!

“Cash Balance 2.0” — New ICR Options
1. Actual Rate of Return
2. Equity Based Rates
3. Fixed Rates
4. Combined Rates

Option 1: Actual Rate of Return

ICR = Actual rate of return on plan assets
Requirement: assets “diversified so as to minimize the volatility of returns.”

✓ Acceptable: mix of bonds and equities
✗ Unacceptable: exclusively in a sector fund
New & Unusual!

First time ever in a defined benefit plan… both positive and negative returns allowed.

Option 1: Actual Rate of Return

**Advantages**
- Minimizes most of the underfunding and overfunding issues

**Disadvantages**
- Volatile returns will have significant impact
- Preservation of Capital Rule

Preservation of Capital Rule

Participant payout can never be LESS than the sum of employer contributions
Preservation of Capital Rule

Example:
- Employer contributes $1,000 for three years
- Negative return reduces participant account balance from $3,000 to $2,800
- Greater of (a) Account Balance or (b) Sum of Employer Contributions
  
Payout to participant = $3,000

Option 2: Equity Based Rates

ICR = Return on a Registered Investment Company (RIC) such as a Mutual Fund

Requirement: “no more volatile than the broad United States equities market or a similarly broad international equities market”

- **Acceptable**: fund tracking the S&P 500
- **Acceptable**: fund tracking a broad-based “small cap” index

**Unacceptable**
A fund concentrated in one industry sector or one global region
Option 2: Equity Based Rates

Need not be invested in the fund being tracked

Example:
ICR = Vanguard S&P 500 index minus 1%
✓ Plan assets could be invested in a fund that tracks the Russell 2000 index
✓ Excess return covers plan expenses and Preservation of Capital Rule
✓ Mitigate participants’ concerns about investment selection

Option 3: Fixed Rates

A stand-alone fixed rate of up to 5%

5%

Option 4: Combined Rates

✓ Allowed: annual floor of up to 4% in conjunction with any Safe Harbor Rate

Example: greater of (a) interest rate on long term investment grade corporate bonds or (b) 4%

✗ Not Allowed: an annual floor in conjunction with Actual Rate of Return or an Equity Based Rate
Option 4: Combined Rates

Other allowable combinations:
- A cumulative floor of up to 3% per annum with any permissible rate
- An annual ceiling in conjunction with any permissible rate

Audience Poll

New Options Create New Issues

1. Compliance Testing
   - Meaningful Benefits Test
   - Non-Discrimination Test
2. Lump Sum Payments
3. Benefit restrictions
Meaningful Benefits Test

- At least 40% of eligible employees or 50 total employees
- **Meaningful Benefit** is an annual benefit at retirement of at least 0.5% of pay
  - Based on age & pay
  - ICR impacts the 0.5% of pay calculation

Meaningful Benefits Test

**Example: 30 year old earning $40,000 per year**

<table>
<thead>
<tr>
<th>Interest Crediting Rate</th>
<th>Meaningful Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.5%:</td>
<td>$71</td>
</tr>
<tr>
<td>4.5%:</td>
<td>$528</td>
</tr>
<tr>
<td>1.5%:</td>
<td>$1,951</td>
</tr>
<tr>
<td>0.0%:</td>
<td>$3,880</td>
</tr>
</tbody>
</table>

- Cost to provide “meaningful benefits” can increase significantly as the ICR decreases

Non-Discrimination Testing

**Comparison: 4.5% vs. 10.0% ICR**

<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Pay</th>
<th>CB</th>
<th>4.5% ICR PS</th>
<th>10% ICR PS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner 1</td>
<td>65</td>
<td>$245</td>
<td>$200</td>
<td>$32</td>
<td>$32</td>
</tr>
<tr>
<td>Owner 2</td>
<td>45</td>
<td>$245</td>
<td>$75</td>
<td>$32</td>
<td>$32</td>
</tr>
<tr>
<td>Employee 1</td>
<td>50</td>
<td>$85</td>
<td></td>
<td>$6.4</td>
<td>$9.3</td>
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<tr>
<td>Employee 2</td>
<td>40</td>
<td>$60</td>
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<td>$4.5</td>
<td>$6.6</td>
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<tr>
<td>Employee 3</td>
<td>30</td>
<td>$50</td>
<td></td>
<td>$3.7</td>
<td>$5.5</td>
</tr>
<tr>
<td>Employee 4</td>
<td>25</td>
<td>$40</td>
<td></td>
<td>$3.0</td>
<td>$4.4</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td>$17.6</td>
<td>$25.8</td>
</tr>
</tbody>
</table>
Compliance Testing

As the ICR decreases:
- Meaningful Benefits costs increase

As the ICR increases:
- Employer contributions needed to pass Non Discrimination Testing increase

Caution:
Volatility will have a significant impact on your Compliance Testing!

Impact on Lump Sum Payments

IRS Limit on Lump Sum Payouts:
- Greater of ICR or 5.5% interest
- Prior to new regulations: 5.5%
- New Regulations could result in ICR > 5.5%

As ICR increases, max lump sum payouts decrease:
- Ultimate lump-sum can be less than what is in the account

Caution: not paying entire account balance as a lump sum would be major problem!
Impact on Lump Sum Payments

Example: 50 year old participant

- 5.5% ICR
  - Max Lump Sum is $1.2M
- 12.5% ICR
  - Max Lump Sum is $350K

Impact on Lump Sum Payments

Solutions:
1. Only pay out lump sums when ICR is low
2. Select the annuity payout option
3. Ceiling on the Interest Crediting Rate

Benefit Restrictions

- Payment of lump sum benefits could be restricted
- Higher Interest Crediting Rates could impose benefit restrictions
- See website for more information
Changing the Interest Crediting Rate

ICR is an accrued and protected benefit
✓ Account balance of $300,000 with a 30-year Treasury ICR
✓ Benefit must not be less than the $300,000 accumulated each year at the 30-year Treasury yield
✓ Even if ICR is lowered

Changing the ICR

To change the Interest Crediting Rate, must meet one of the two requirements:
1. Wearaway
2. Sum of Two Accounts
Option 1: Wearaway

Set Up Two Hypothetical Accounts:

- **Account A**
  - Beginning balance = current account balance
  - Grow each year using original ICR
  - No future contributions

- **Account B**
  - Same beginning balance as Account A
  - Credited with new ICR and
  - Add new contributions

Wearaway

Payout is greater of:

- Account A or
- Account B

*No participant will receive less than account balance at date of change with interest at the old ICR*

Wearaway

The problem simply 'wears away:' after a few years Account A becomes irrelevant for most participants
Example: Wearaway

- Account Balance is $300,000
- Contribution is $50,000
- Old ICR is 30-year Treasury rate: 4.00%
- New ICR is actual return: 3.50%

<table>
<thead>
<tr>
<th>Date</th>
<th>Account A</th>
<th>Account B</th>
</tr>
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<tbody>
<tr>
<td>1/01/2011</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>3.5% Interest</td>
<td>12,000</td>
<td>N/A</td>
</tr>
<tr>
<td>2011 Contribution</td>
<td>N/A</td>
<td>10,500</td>
</tr>
<tr>
<td>12/31/2011</td>
<td>$312,000</td>
<td>$360,500</td>
</tr>
</tbody>
</table>

Wearaway: Exceptions

Account A could be greater than Account B:
- Terminee leaves his money in the plan
- Plan is frozen and the employer elects not to make any future contributions.

Option 2: Sum of Two Accounts

Set Up Two Accounts:

- **Account A**
  - Beginning balance = current account balance
  - Grow each year using original ICR
  - No future contributions

- **Account B**
  - Beginning balance = $0
  - Credited with new ICR &
  - Add new contributions

Payout is Sum of Account A + B
Coming Soon?

- Multiple ICRs Within a Plan
  - Participant Direction
  - Target Date Funds
  - Not yet available but under IRS consideration
- More Frequent Valuations
  - Quarterly
  - Daily

Conclusions

**Advantages**
- Eliminates most overfunding and underfunding issues
- ICR flexibility
- IRS support

**Disadvantages**
- Testing Issues
- Lump Sum Payout Issues
- Benefit Restriction Issues
Predictions

1. Many will continue using a safe harbor rate (30-yr Treasury)
2. ICR = Actual Return, but continue with a strategy tracking a safe harbor rate
3. ICR = Equity Based Rate, but add a ceiling

Audience Poll

Recommendation

ICR Impact Analysis:

1. Study impact of different ICR options on plan design
   a. Compliance testing
   b. Lump sum payouts
   c. Benefit restrictions
2. Recommend optimal ICR
3. If applicable, create a transition plan
Kravitz consultants will advise you of next steps to proceed with an ICR Impact Analysis over the next year.

Contact Us

Anyone interested in learning more about ICR Impact Analysis or other plan design issues, please call:

(877) CB-Plans

- Design and administer retirement plans for 1,200+ clients nationwide
- Founded October 15, 1977
- National leader in Cash Balance Plans since 1989; founded Cash Balance Coach®
- Los Angeles & New York + 7 satellite offices