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Market-Based Cash Balance Plan (MBCBP): Frequently asked questions

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The retirement landscape is constantly evolving, with the predominant trend being away from traditional defined benefit (DB) pension plans toward 401(k)-style defined contribution (DC) plans. However, defined benefit plans are making a comeback in a hybrid format known as "cash balance," which mimics the look and feel of a 401(k) plan but comes with special features that can appeal to employers and employees alike. We have outlined ten questions that most frequently come up when employers are deciding whether to sponsor a cash balance plan.

Read the full FAQ, or skip to a specific question via the links below:

1. What is a cash balance plan and how does it fit into the evolving retirement plan landscape?
2. What is a Market Based Cash Balance Plan (MBCBP)?
3. How are MBCBPs typically invested?
4. Do employees need to consider the MBCBP asset allocation when making their 401(k) investment decisions?
5. What has led to the growth in cash balance plans? Why would employers add a cash balance plan if they already have a defined contribution plan?
6. What options for determining interest credits do plan sponsors have when setting up a cash balance plan?
7. What additional considerations apply to the interest credits in a MBCBP? Does everyone have to get the same interest credits?
8. Why would employers choose an MBCBP?
9. Does everyone get the same benefit level in an MBCBP?
10. Why have MBCBPs been attracting more attention from employers lately?

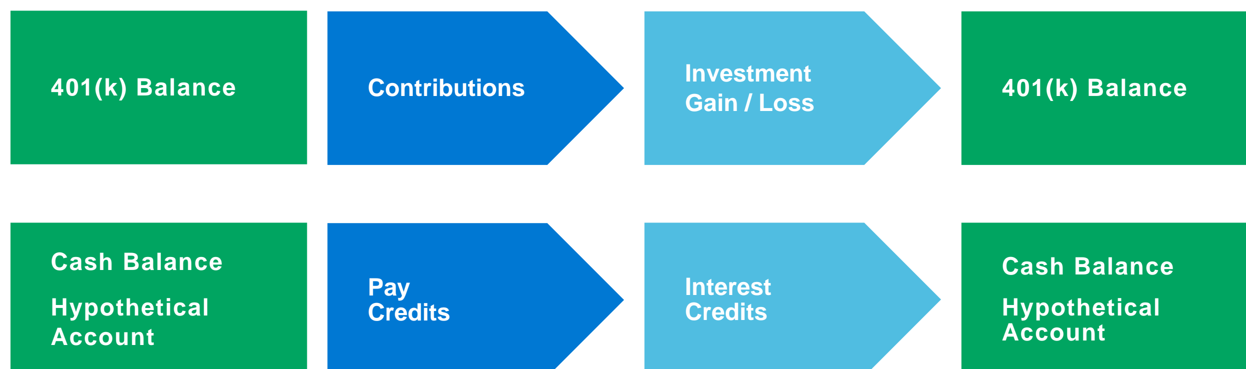
Q1: What is a cash balance plan and how does it fit into the evolving retirement plan landscape?

A cash balance plan is a type of "hybrid" retirement plan, combining attractive characteristics of both defined benefit (DB) plans and defined contribution (DC) plans. In a cash balance plan, all assets are held in a pooled account and a participant's benefit is determined by the terms of the plan document, both features of a DB plan. However, each participant's benefit is communicated in terms of a hypothetical account balance, which mimics the look and feel of a DC plan from the participant's perspective.

A cash balance account grows through two components:

- **Pay credits:** Often defined as a percentage of an employee's annual salary—in a 401(k) plan this would be equivalent to the employee or employer contribution.
- **Interest credits:** Can be a fixed rate or a variable rate—in a 401(k) plan this would be equivalent to the investment earnings or losses. Plan sponsors can choose among several allowable methods for defining the interest credits. They include fixed interest crediting rates up to 6% per year, or a menu of allowable variable rates that link to inflation experience, bond yields, mutual funds, exchange-traded funds (ETFs), collective investment trusts (CITs), or the actual trust rate of return.

FIGURE 1: HOW A CASH BALANCE PLAN GROWS FROM ONE YEAR TO THE NEXT



While the number of open, ongoing traditional DB plans has declined in recent decades outside of public sector and union employment, the prevalence of cash balance plans has grown significantly. In 1998, about 57% of Fortune 500 companies offered DB plans to newly hired employees, with the vast majority using traditional DB designs. By 2019, only 14% of such companies offered DB plans to new hires. However, for employers that did provide a DB plan, over 80% were in the form of a hybrid plan like a cash balance plan.[1]

In subsequent questions, we will learn about what is driving the trend toward cash balance, and market-based cash balance more specifically.

Q2: What is a Market Based Cash Balance Plan (MBCBP)?

A Market Based Cash Balance Plan (MBCBP) is a special type of cash balance plan. This type of plan uses the actual return on plan assets as the "interest credits." Thus, if the interest credits are defined as the actual return on plan assets, that makes MBCBP interest credits equivalent to investment earnings or losses in a 401(k) and, therefore, an MBCBP plan has risk similar to a 401(k) plan (for the employer).

While that sounds very similar to a 401(k) plan, there are some differences:

- As with any cash balance plan, assets are pooled and investment decisions are made at a plan-wide level, rather than being participant-directed as in a 401(k).
- MBCBPs must adhere to the "preservation of capital" rule, which requires that the cash balance account distributed to an employee be greater than or equal to the sum of the pay credits over an employee's career.
- MBCBPs often choose to add a "cap" on the annual interest credit because of nondiscrimination testing rules that don't apply to 401(k) plans.

In summary, a key feature of MBCBPs is that the growth in employee account balances (and thus plan liabilities) is aligned with the actual returns achieved on the invested plan assets. When combined with an appropriate funding policy, this allows plan sponsors to maintain a plan that is expected to remain fully funded regardless of actual investment performance. In such a design, the plan sponsor bears little investment risk long-term. Instead, a large portion of both the risk and reward of investment performance is passed through to employees, because returns affect the benefits paid. The exact degree of this risk passthrough can be customized and ultimately will depend on plan design specifics.

1. Retirement offerings in the Fortune 500: 1998-2019, WTW.

Q3: How are MBCBPs typically invested?

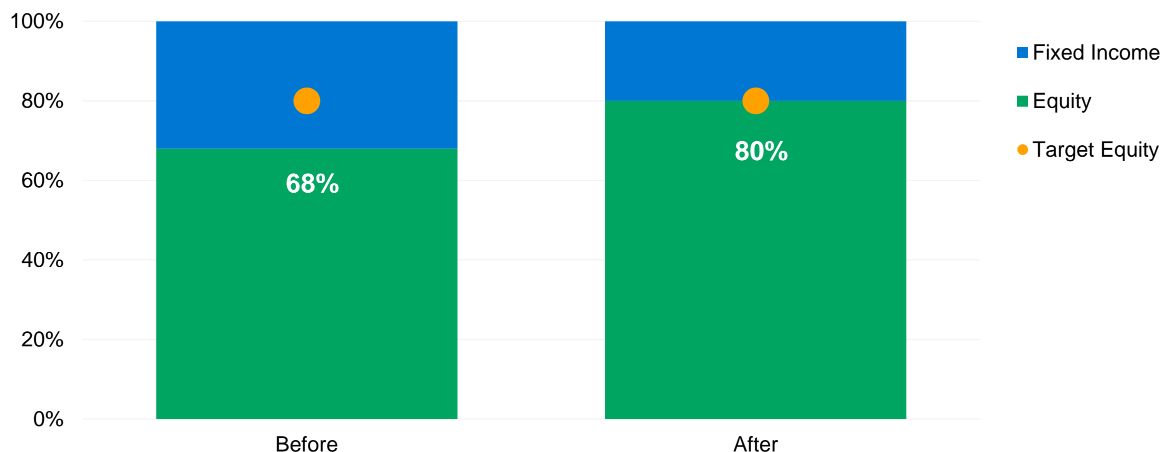
Given that asset returns determine benefits paid to employees in an MBCBP, the investments tend to be more conservative than the average 401(k) allocation because the risk level needs to work for younger employees as well as those with a few years left until retirement. For example, the typical equity exposure in an MBCBP ranges from 20% to 50%, which could be below the risk tolerance of some employees.

Q4: Do employees need to consider the MBCBP asset allocation when making their 401(k) investment decisions?

An MBCBP is often sponsored alongside a 401(k) plan. The typically conservative investment approach of MBCBPs puts a spotlight on the need for employees to consider their overall risk tolerance and use their 401(k) balance to hit their target asset allocation, if needed.

We've illustrated how this works in Figure 2. Assume that an employee wants to achieve a total allocation of 75% equity and 25% fixed income investments. If they apply that 75%/25% split in their 401(k) balance, the overall equity allocation will be below their target when viewed on a combined basis with the more conservative portfolio supporting their cash balance benefit, as shown in the "before" result. However, by rebalancing their 401(k) allocation more toward equity, the employee can still achieve their targeted allocation in total.

FIGURE 2: EFFECT OF USING 401(K) TO ACHIEVE TARGET EQUITY EXPOSURE IN LIGHT OF MORE CONSERVATIVE MBCBP ASSET ALLOCATION



Q5: What has led to the growth in cash balance plans? Why would employers add a cash balance plan if they already have a defined contribution plan?

One reason for the growth in cash balance plans is that some employers find it difficult to provide large enough tax-deferred retirement savings opportunities through a defined contribution plan alone.

Tax-qualified defined contribution plans are subject to several restrictions, including:

- A limit on the amount of compensation that can be considered ($350,000 in 2025)
- A limit on participant deferrals ($23,500 in 2025)
- A limit on total contributions to the plan ($70,000 in 2025)

For employees who earn well above the compensation limit, including doctors, lawyers, engineers, and other professional service job types, the savings opportunity provided in a qualified defined contribution plan alone may not allow the accumulation of sufficient assets to retire comfortably. High earners need to replace more of their preretirement income through employer sponsored plans and personal savings to maintain their lifestyle in retirement compared to lower wage earners because Social Security benefits replace a smaller portion of pre-retirement income for high earners.

The benefits provided through a DB plan—including cash balance plans—are separate and do not count toward DC plan limits. As a result, for employers with a highly-paid workforce, providing both a defined contribution and a cash balance plan can be a powerful combination to enhance retirement security. This is why a large portion of the growth in cash balance plans in recent years has included employers with well-paid professional staff, such as those in the airlines, oil and gas, legal, and medical fields.

Q6: What options for determining interest credits do plan sponsors have when setting up a cash balance plan?

There is a menu of permissible interest crediting rates a sponsor may choose from when designing a cash balance. These options include a fixed crediting rate (up to 6% per year), several allowable rates that are tied to an inflation or bond-related index, and investment-based rates. Figure 3 provides details of the three common types of interest crediting approaches, including investment-based rates (which are the defining feature of an MBCBP).

FIGURE 3: COMMON INTEREST CREDITING OPTIONS FOR EMPLOYERS

INTEREST CREDITING BASIS	DETAILS
Fixed rate	Cannot exceed 6% per year
30-year Treasury rate	Can apply a floor rate as high as 5%
Investment-Based Rates (“MBCBP”)	Allowable options: ▪ Actual rate of return on plan assets, subset of plan assets, or annuity contract ▪ Rate of return on certain regulated investment companies (RICs) ▪ Cumulative floor up to 3% per year is allowed

In the first wave of cash balance plan designs, basing interest crediting on a fixed rate or linking it to a 30-year Treasury bond were the most common approaches selected by plan sponsors. However, plan sponsors have shown a growing interest in using investment-based rates in recent years. One major reason for the change is regulatory clarity that was provided for this approach when the IRS finalized new hybrid plan rules in 2010 and 2014. Another contributing factor is the challenge experienced by sponsors using Treasury-based rates during periods of significant interest rate volatility over the last two decades.

Q7: What additional considerations apply to the interest credits in a MBCBP? Does everyone have to get the same interest credits?

For an MBCBP, federal regulations require that the selected investments for the trust assets be diversified. An MBCBP is also subject to the general fiduciary rules of ERISA, which also apply to 401(k) plans.

A cumulative floor of up to 3% per year can be used by employers who want to partially insulate employees from the volatility inherent in investment markets. Such a floor guarantees that employees get a compounded return over the length of their participation in the MBCBP of at least 3% (or other selected floor rate provided the rate is no greater than 3%). However, an annual floor on MBCBPs is not allowed because that would prove to be an “above market” return, which violates the regulations.

Employers with nondiscrimination testing concerns frequently also apply an annual cap on their MBCBPs to prevent compliance challenges that may occur when returns are too high. For example, such a rate could require unplanned additional contributions to the 401(k) in order to pass compliance testing. And, when returns are in excess of the plan's annual cap, the surplus can be "banked" to offset the cost of future pay credits or to self-insure against preservation of capital cost (however unlikely that may be). Future federal law or regulations may change how nondiscrimination testing is performed and remove the need for some employers to have a "cap" on annual returns.

For most MBCBPs, the same interest credit is applied to all participants. However, it is also possible to structure a plan where different groups of plan participants receive different interest credits based on different equity allocations, for example. Given that age cannot be used to determine the group, employers typically use years of service with the employer to vary the risk allocation among employees.

Q8: Why would employers choose an MBCBP?

For employers interested in sponsoring a cash balance plan, selecting an MBCBP design can be appealing in several ways:

- **Low employer risk:** The plan sponsor can benefit from the combination of a cash balance plan and a DC plan without taking on significant additional investment risk on a large pool of assets.
- **Employee appreciation:** Employees can understand and appreciate the benefit easily, because it is structured as an account balance and fluctuates with actual market returns like a 401(k) plan.
- **Investment upside:** Unlike a fixed rate cash balance plan, employees have the potential to benefit from the upside of higher investment returns and still retain downside protection due to the "capital preservation" rule.

Q9: Does everyone get the same benefit level in an MBCBP?

No, the benefit level does not have to be uniform in an MBCBP. Plan sponsors that wish to differentiate the level of benefits can do so through the design of the plan's pay credits.

For example, sponsors can choose to design a plan that provides different tiers of credits depending on participant age, years of service, or a combination of both. In addition, pay credits can be varied based on any objective business criteria such as location, business unit, or job type. A tiered credit structure can be used to reward longer-service participants and provide incentives for retention—a benefit of traditional defined benefit plans that is sometimes lost by moving to a cash balance plan.

Figure 4 shows an example of how a plan design can be calibrated to the needs of a diverse workforce.

FIGURE 4: SAMPLE PLAN DESIGN FOR DIVERSE WORKFORCE

Years of Service	Division A	Division B	Division C
Less than 5 years	7%	6%	$5,000
5 – 10 years	9%	8%	$7,000
11 – 15 years	12%	10%	$8,000
More than 15 years	15%	10%	$10,000

Observations:

- **Retention incentives**: The sample design incentivizes tenure for all divisions.
- **Future adjustments:** Division C's fixed dollar benefit levels could be indexed to inflation or might be tailored to the needs of a collectively bargained unit and, therefore, included in the labor agreement. It's assumed that any fixed dollar schedule will periodically be adjusted.
- **Mapping the benefits:** An employer could use any objective business criteria to define which employees get Division A, B or C benefits.

Q10: Why have MBCBPs been attracting more attention from employers lately?

The reason that an employer moves to an MBCBP will inherently be specific to their strategic goals and priorities. The list below outlines the recent motivations driving more companies to consider implementing an MBCBP.

- **Stronger Retirement Program with Lower Risk:** It allows employers to offer a defined benefit plan without the risk typically associated with such designs. With an MBCBP, the enterprise no longer suffers business disruption from the pension if investment markets suffer a downturn. This allows an employer to be more focused on its core business than if it sponsored a traditional defined benefit plan.
- **Boosts Tenure Incentives:** Recent regulatory changes have allowed MBCBPs to include tiered schedules such as those outlined in Question 9 that incentive tenure, which wasn't possible before the SECURE 2.0 Act of 2022. Higher-than-desired rates of turnover complicate workforce management for employers; therefore, a design that transparently incentivizes tenure supports the objective of one generation of employees mentoring the next and leaving the company's future in capable hands. This can be particularly important in fields with highly specialized labor (such as oil & gas or the medical field).
- **Competitive Hiring Edge:** Related to the above points, offering a pension can be a significant market differentiator when faced with a competitive job market. Depending on industry, offering a pension benefit can make an employer stand out and provides a compelling way to enhance the attraction and retention of a talented workforce.

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