Fidelity Workplace Consulting

Market-Based Cash Balance Plans: Re-Evaluating an Often Overlooked Plan Design

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There are good reasons why market-based cash balance plans have been embraced by professional partnerships and law firms. But these plans offer a unique opportunity that shouldn't be overlooked by other employers.

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Fidelity INVESTMENTS

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An attractive opportunity for all types of plan sponsors

The Pension Protection Act of 2006 prompted the introduction of the market-based cash balance plan (MBCB), a plan that allows investment risk to be shared similar to the way it's done in a defined contribution (DC) plan. Since their introduction, MBCB plans have grown in popularity among professional service organizations and partnership groups.

Yet larger corporate sponsors have mostly ignored them, continuing to sponsor traditional cash balance (CB) plans or relying instead on a DC plan for their main retirement plan. Are these plan sponsors missing an opportunity? What benefits does an MBCB offer that other cash balance – or even DC – plans don't?

Key Takeaways

- Market-based cash balance plans have been popular with certain employers but have been overlooked by larger companies. It's a good time to revisit this opportunity.
- This type of plan can offer greater retirement benefits in a tax-sheltered vehicle.
- Fidelity Workplace Consulting can help you evaluate the various aspects of cash balance plan structures to help you determine which makes sense for your organization.

What makes cash balance plans appealing?

CB plans are tax-qualified plans that provide your participants with an additional opportunity to earn tax-deferred retirement benefits beyond a DC plan. CB plans are often referred to as "hybrid" defined benefit (DB) plans because they have characteristics of both a DB and a DC plan.

CB plans accrue benefits payable at a future date and, like a DC plan, the participant's benefit is based on the value of their "individual" account. MBCB plans are a specific type of a CB plan where the growth of the account is tied to the actual return on plan assets.

The chart below highlights some of the similarities and differences between market-based cash balance and traditional cash balance structures.

> **Market-based cash balance plans are popular with physicians and law firms for a reason: They offer greater retirement benefits in a tax-sheltered vehicle. We believe a market-based cash balance plan deserves a closer look by larger corporate sponsors right now. It's a defined benefit plan that hits a sweet spot between DB and DC.**

– Shams Talib, Executive Vice President, Head of Fidelity Workplace Consulting

Similarities and differences between MBCB and traditional CB plans

Similarities

Account Balance	Pay Credit	Interest Credit	Payment of Benefit
Each is a defined benefit plan. Participants' benefits are defined as an account balance. The balance grows with pay credits and interest credits. Account balances are hypothetical only - as all assets are held in the plan trust, not in separate individual accounts by participant.	Participants earn pay credits for each year of service with the company. Pay credits stop when participant leaves the company.	Interest credit is applied to the account balance each year. Interest credits don't stop when participant leaves the company. They are earned until the balance is taken out of the plan at termination or retirement.	Typically, benefits are paid out as a lump sum. Because it is technically a DB plan, annuity options must be offered as well.

Differences

Interest Credit	Payment of Benefit
In traditional CB plans, the interest credits often take the form of a fixed interest rate, a floating rate, or a combination of the two. MBCB plans base the interest credits on how plan assets actually perform.	IRS rules require that a participant's total return on their MBCB balance when they take their money out cannot be less than 0% in the aggregate. This does not forbid negative returns in a year, it just means that a participant must at least get the sum of their pay credits out of the plan when they take their money. Many MBCB plans put a cap on annual returns that are credited to participant accounts (e.g., 10%) to address non-discrimination testing and regulatory compliance. A cap has an added bonus of providing some cushion for the plan sponsor against having to pay for the 0% cumulative floor.

5 Five key reasons why large plan sponsors are converting to MBCB plans

1 In the current low interest rate environment, traditional CB plan sponsors are under pressure – particularly those with fixed interest crediting rates or "greater-of" rates

It's harder to meet those guarantees without taking on more investment risk. Indeed, this is the opposite of how the pension world is moving – trying to reduce risk, not increase it.

MBCBs don't have the pressure to meet a guarantee each year. While there is still a guarantee that the total return on the fund be at least 0% at payout, that's not an annual requirement – and your organization can put a cap on the annual returns in the MBCB design to allow you to build up a reserve to cover this requirement in the (less likely) scenario that it applies.

2 MBCB designs help address other types of risk beyond low interest rates

Even if a traditional CB plan doesn't have a minimum fixed rate, this can be a challenge to manage from a risk perspective.

Question: If your plan credits the 10-Year Treasury rate – how can you hedge your risk associated with this rate? **Answer:** You can't. The 10-Year Treasury Rate is not an investible instrument. You could buy a 10-Year Treasury bond, but you would be locking in the 10-Year rate at time of purchase. Meanwhile, your plan's rate would fluctuate as the markets for 10-Year Treasuries moved.

By moving to a design where the crediting rate is tied to investment performance, your risk associated with interest crediting is greatly reduced. The incentive to make "bets" is also reduced, because there is no clear payoff for you as the plan sponsor.

- For example, in traditional DB plans, we recently have seen sponsors investing their fixed income at shorter durations than their liability, anticipating a rise in rates that will benefit the plan.
- In a MBCB plan, there would be no logic to such a bet since the performance of the fund would impact the assets and liabilities similarly. In fact, one might argue that it's better to maintain a more moderate or conservative investment strategy to shield participants from extreme volatility in their accounts.

3 The ability to deliver greater benefits in a tax-sheltered vehicle

This is a primary motivator for professional services organizations to sponsor MBCB plans, but there's no reason the same motivation couldn't apply to other plan sponsors. And the generous maximums in a MBCB plan can mean a sizeable lump sum opportunity.

- In a DC Plan, the annual additions – what the employee and employer together contribute to the plan – can't exceed $58,000 in 2021. A DB plan's limits are separate and much higher.
- The DB 415 limit allows for a maximum $230,000 per year annuity at retirement age. In lump sum terms for 2021, this is nearly $3 million at age 62. If we translate that $3 million end goal into an annual contribution each year until retirement age, the result for most participants – particularly those 40 or older -- is a much higher number than $58,000. What's more, the DB limits function independently of the DC limits. No matter the size of the DB benefit earned in a year, there is another $58,000 in potential additions to the DC plan each year.
- This could be an attractive benefit for higher-paid executives. The ability to take advantage of this will depend on a number of factors, including plan demographics, other plan designs in the controlled group, and non-discrimination testing. An actuary can help you assess your options.

4 Greater participant transparency

For example, in a traditional CB plan, you might be providing a 4% annual pay credit to the account, but interest is only credited at the 10-Year Treasury rate. Based on where rates are today – 1.5% for a 10-Year Treasury – ultimately what you're providing is worth a lot less than if the 4% had been put into a DC plan and invested in a balanced portfolio.

Put another way, that 4% pay credit is really like a DC plan where you contribute only 1.7%.[1] The participant is not likely to understand when you're telling them they're getting 4%, but it's really worth a lot less. Switching to an MBCB design increases transparency because any pay credits generally will be earning market returns, more like a DC plan.

5 Funding flexibility for plan sponsors

If a temporary disconnect between assets and liabilities occurs – for example, participants retire and their cumulative return is negative, thus they are owed the 0% minimum guarantee – the IRS allows any shortfalls to be made up over a 15-year period.

Each decision weighs risk and reward. We can help you see every aspect.

There are obviously a lot of considerations in moving to an MBCB design, particularly if the current design is a traditional CB plan. But if you are looking at changes to your benefit programs, or considering moving to a traditional CB plan, evaluation of an MBCB plan design is warranted.

Fidelity can work with you to understand how the above benefits of a MBCB plan may apply in your situation. Our retirement consulting team in Workplace Consulting are industry professionals with extensive experience and deep industry knowledge in plan design and de-risking. We can show you the potential impact of a MBCB plan solution for your specific situation and help you determine the right path forward.

For more information on our MBCB plan consulting services, please contact your Fidelity Managing Director or email the Fidelity Workplace Consulting group at FidelityWorkplaceConsulting@fmr.com, or visit https://www.fidelityworkplace.com/s/workplaceconsulting.

[1] Consider a 40-year-old who earns $100,000 and receives a 4% pay credit. If that is credited with a 10-Year Treasury rate of 1.5% per year, that pay credit would grow to $5,800 at age 65. A 1.7% contribution, or $1,700, if it grows by 5% per year (i.e., a reasonable expected return on a balanced portfolio of stocks and bonds), it would equal the same $5,800 at age 65.