

Cash balance basics

Cash balance plans are a relatively small but quickly growing segment of the retirement landscape. We'll first describe, at a high level, what cash balance plans are and how they work. Next, we'll explore reasons why some employers are adopting these plans and how recent legislation may support further growth. Finally, we'll outline some key design considerations for companies looking at how cash balance plans could help achieve specific benefits-related goals.

What is a cash balance plan?

A cash balance plan is a type of defined benefit (DB) plan that's structured to look and feel like a traditional defined contribution (DC) plan (e.g., a 401(k)) from the participant perspective. Cash balance plans are often referred to as hybrid plans because they incorporate features of both traditional defined benefit plans and defined contribution plans. Similar to a DC plan, cash balance plan participants have a benefit that's expressed as an account balance that accumulates over time through a combination of employer contributions (or pay credits) and investment earnings (or interest credits). However, these are hypothetical account balances, meaning that assets are not actually allocated to individual participants. Therefore, each plan participant does not direct how assets are invested or have an individual investment account.

Cash balance plans are generally subject to the legal and regulatory requirements applicable to traditional DB plans. The benefits paid to plan participants are determined by a formula defined in a legal plan document subject to Internal Revenue Code (IRC) rules. The benefits are generally employer funded, and all plan assets are invested

in a single qualified plan trust. The plan sponsor (and/or its delegates) operates the trust in a fiduciary capacity, often with the assistance of investment advisors, and is subject to regulatory requirements defined in the Employee Retirement Income Security Act of 1974 (ERISA).

As a type of defined benefit plan, cash balance plans must:

- Meet coverage and nondiscrimination testing requirements
 - Use actuaries to determine liabilities and funding requirements
 - Have administration, including calculations of benefit amounts and optional forms of payment
 - Comply with legal requirements, including participant notices and spousal protections
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Intended for plan sponsor and consultant use.

Investment products:

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value
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How does a cash balance plan work?

In a cash balance plan, each eligible participant’s hypothetical account value accumulates over time as defined by the terms of the plan. The two primary components that drive the growth in those account balances are pay credits and interest credits.

- **Pay credits** represent the contributions made to the account values for the participants each year. They’re usually defined as a percentage of pay up to a limit, though they could also be defined in dollar terms. It’s also common to provide varying pay credits to participants based on age or service, with more seasoned employees receiving higher pay credits to encourage retention. Depending on the objectives of the plan sponsor, pay credits can be defined differently for different groups and even by individual, but nondiscrimination testing requirements must be satisfied.

- **Interest credits** represent the investment growth on the underlying balance. Interest crediting rates (ICRs) generally fit into a few basic structures (see chart below). Floors and caps (for example, minimums and maximums) on interest crediting rates are often used to limit volatility and ensure compliance with accrual rules. Also, note that the choice of the interest crediting methodology will have major implications for how the plan assets can be invested to limit funded status volatility. Although there is some flexibility in designing the interest crediting rate, it must not exceed a market rate of return calculated using one of the interest rates specified in IRC regulations and must adhere to other specific rules.

Most common types of interest crediting rates

	Advantages	Disadvantages
<p>Fixed interest rate A specific, predetermined annual rate not greater than 6% (for example, 4% or 5%).</p>	<ul style="list-style-type: none"> • Offers simplicity for participants. • Reduces administrative complexity. 	<ul style="list-style-type: none"> • May not keep pace with market growth. • Can create funding risk for the employer if asset returns differ significantly.
<p>Interest rate based on benchmark yields Tied to a benchmark such as the 10-year or 30-year Treasury rate.</p>	<ul style="list-style-type: none"> • Sets a return target that should be achievable with a conservative investment strategy. 	<ul style="list-style-type: none"> • Provides fairly low credits for plan participants. • Creates asset-liability mismatch issues for plan sponsors.
<p>Market-based rate Defined to align with a combination of indexes or tied to the actual rate of return on the plan’s investments.</p>	<ul style="list-style-type: none"> • Gives participants an opportunity to share in the plan’s investment growth. • Reduces balance sheet volatility and funding risk for the plan sponsor by aligning interest credits with asset performance. 	<ul style="list-style-type: none"> • Shifts market risk and associated uncertainty to plan participants, requiring careful communication to manage participant expectations.

Why are cash balance plans growing in popularity?

Over the last decade, cash balance plan adoption has grown as plan sponsors have learned more about how they can be used, and as recent legislation has supported innovations in the space. “Hybrid” cash balance plans convey some key advantages over both DC and traditional DB plans, and different sponsoring companies may be more focused on some aspects of the design than others. They certainly aren’t a silver bullet, though. Plan sponsors often use a DC plan in conjunction with a cash balance plan to take advantage of the benefits of both types of plans.

How cash balance plans compare

Relative to DC plans

- Have significantly higher contribution limits than 401(k) plans — especially important for employers with higher paid employees.
- Provide more flexible distribution options for retirees (both lump sums and annuities).
- Offer a higher level of protection for participants, with both the Preservation of Capital rule and PBGC guarantees in place, subject to some limitations. These protections ensure that a participant’s cash balance value at retirement will be at least equal to the summation of the pay credits received through a career, even if investment performance is poor.
- Allow for the use of more sophisticated investment strategies, including professional management, the use of alternative investments and the availability of illiquid asset classes not typically offered in DC plans.

Relative to traditional DB plans

- Look more like 401(k) plans with individual balances accumulating over time.
- May be easier to understand than the complicated formulas associated with traditional DB plans. This can help attract and retain talent — a primary reason plan sponsors offer retirement benefits to their employees.
- Can be designed and invested to limit balance sheet volatility for the plan sponsor, while still taking advantage of the long-term return potential of equities and other growth assets. Balance sheet volatility can be managed in a traditional DB plan with liability-driven investing. But this requires primarily investing in fixed income rather than growth assets, which can increase the long-term costs of maintaining the program.

A well-designed cash balance plan can deliver many of the benefits of DC plans and traditional DB plans to both plan sponsors and plan participants. Furthermore, recent legislation has provided additional clarity and flexibility for plan sponsors in designing and managing their cash balance plans.

Key cash balance provisions of SECURE 2.0 include:

- More support and regulatory certainty for plan sponsors wishing to adopt market-based cash balance designs
- Relief for transitioning designs, such as changes to interest crediting rates, including anti-cutback relief
- Easing nondiscrimination testing requirements, especially for frozen cash balance plans

What are the key design considerations for plan sponsors?

The most important elements of a cash balance plan are the structure of the pay credits and interest credits, as described earlier. Together, those elements will determine how benefits accumulate over time for plan participants, how much employer cash will be required to fund those benefits and how the assets should be invested.

Arguably, the level of pay credits offered is the chief consideration in determining plan cost for the employer (assuming the interest crediting can mostly be matched by actual asset returns over a sufficiently long investment horizon—though past performance does not guarantee that this will always hold in the future). At the same time, the nature of the interest crediting rate is a primary determinant of how the plan assets should be invested, though there are certainly other considerations involved.

Focusing on **pay credits** first, plan sponsors should consider:

- 1. What level of benefits do participants require to meet retirement needs?** Many employers may wish to facilitate an orderly transition into retirement by ensuring that participants' retirement needs are adequately met.
- 2. What level of benefits will be sufficient to attract and retain talent?** More competitive industries may require higher levels of benefits. Also, if a cash balance plan is being offered alongside a 401(k) or other DC plan, the overall value of benefits should be considered.
- 3. Which—if any—participant groups should employers focus on?** Some employers may be more focused on attracting new talent, who may be younger. Others will be chiefly concerned with retaining certain key highly tenured participants. Age- or service-based pay credits may be structured to provide varying benefit levels to different groups to further certain goals along those lines, though nondiscrimination testing requirements must be considered.

- 4. What budget is available to provide retirement benefits?** Cash balance plans are generally employer funded, so cash will have to be available to fund the associated costs. Should a cash balance plan become overfunded, there is some funding requirement flexibility relative to DC plans—but there is the potential for unexpectedly high funding requirements in an unfavorable market environment.

Designing an **interest crediting rate** methodology necessitates careful consideration. A fundamental decision is whether to provide a relatively lower but safer ICR for plan participants with a fixed or Treasury-linked ICR, or to pass along investment risk and the associated opportunity to plan participants with a market-based ICR.

- At the risk of overgeneralizing, **market-based designs** may provide benefits to both plan participants and plan sponsors in certain situations. By linking the ICR to investment performance, plan participants could benefit from long-term growth in equity markets, while plan sponsors may appreciate the natural matching between assets and liabilities, which can reduce funded status volatility and uncertainty.
- However, a **fixed or Treasury-linked ICR** can provide more consistent safe returns for participants while presenting an opportunity for plan sponsors to out-earn the ICR to drive funded status improvement and/or to offset future cash contribution requirements.

Certainly, participant-related considerations like those described above are relevant here, too. With fixed or Treasury-linked ICRs there's a balancing act between providing a sufficiently high ICR to satisfy plan participants and not providing so high an ICR to create funding issues and undue risk for the plan sponsor. Even fairly low guaranteed returns may be challenging to achieve consistently when investing in risky and volatile markets.

Conclusion

Cash balance plans have been growing in popularity because they can be a powerful and flexible tool for employers to efficiently deliver valuable retirement benefits to their employees. They're not a "one-size-fits-all" solution, and many organizations can be well served by other types of retirement plans. That said, when utilized in a retirement benefit program, a cash balance plan can and should be customized to meet the goals and objectives of its plan sponsor. As part of that process, it's critical to understand the interactions between the nature of the interest crediting rate, associated asset return requirements, and implied investment risk and volatility.



For more on this topic and other important considerations for plan sponsors looking to optimize their retirement program and the associated investment strategy, please check out our companion whitepaper, *Optimizing Cash Balance Investments and Design*.

Intended for plan sponsor and consultant use.

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