

Optimizing cash balance investments and design

Cash balance (CB) plans are an increasingly popular retirement tool for employers. We'll focus primarily on investment strategies for CB plan assets, considering the nature of the liabilities and interactions with various types of interest crediting rates. We'll contrast traditional CB designs that feature Treasury-linked or fixed interest crediting rates with market-based designs — in terms of how they should be invested and what benefits they provide to plan sponsors and participants.

We also include:

- An introduction to incorporating participant choice in cash balance plans.
- A discussion of strategies viable for employers managing a CB and defined contribution (DC) plan.
- Considerations for plan sponsors aiming to transition from one plan design to another, including how SECURE 2.0 has enabled such transitions.

Note: This paper is focused on substantial benefit offerings for employers with more than a few employees, not single participant/owner CB plans.

Additional information

For more background regarding cash balance plans, please see our companion piece, *Cash Balance Basics*.

Considerations for investing cash balance plan assets*

Along with objectives and risk tolerance, plan design is a prominent consideration for sponsors of cash balance plans, with a special emphasis on the interest crediting rate.

Traditional cash balance designs

With Treasury or fixed interest credits, a conservative allocation may be best, but some asset-liability mismatch risk will be unavoidable. These types of CB designs effectively prescribe a return target for plan investments. It's usually a rate that may appear to be easily achievable over the long run (often 3%–5%), but year-by-year volatility could present issues for a plan sponsor.

With these types of designs, fairly conservative allocations tend to be used (for example, 20–40% growth assets and 60–80% fixed income investments, depending on risk tolerance). Even with an asset allocation that's predominantly fixed income assets, there's potential for falling short of the return target in any given year. For instance, fixed income assets can produce negative returns, particularly if they are longer in duration and interest rates rise.

*Plan investment decisions are a fiduciary responsibility under ERISA. This paper is not intended to provide individualized advice, but rather high-level considerations for plan sponsors and/or investment fiduciaries to consider when thinking about CB plan investment decisions. Please consult your investment advisor/professional.

Intended for plan sponsor and consultant use.

Investment products:

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value
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This touches on another investment-related issue for plans with interest crediting rates tied to Treasury yields: Liability-driven investing can be complicated to the point that a tight hedge is nearly impossible to achieve. (For more on liability driven investing, please see our other papers on the topic.) For example, consider a plan with interest crediting tied to the yield on 30-year Treasury bonds. A return equal to that yield should theoretically be achievable on an expected basis or over the long term simply by investing in 30-year Treasury STRIPS (zero-coupon governmental bonds). However, in a scenario where the 30-year Treasury rate increases significantly, the plan assets will lose value, as bond prices are inversely related to their yields. Simultaneously, the plan's liabilities may in fact rise over the next several years because the interest rate credited to participant accounts will be higher. Therefore, hedging these liabilities precisely may not be possible.

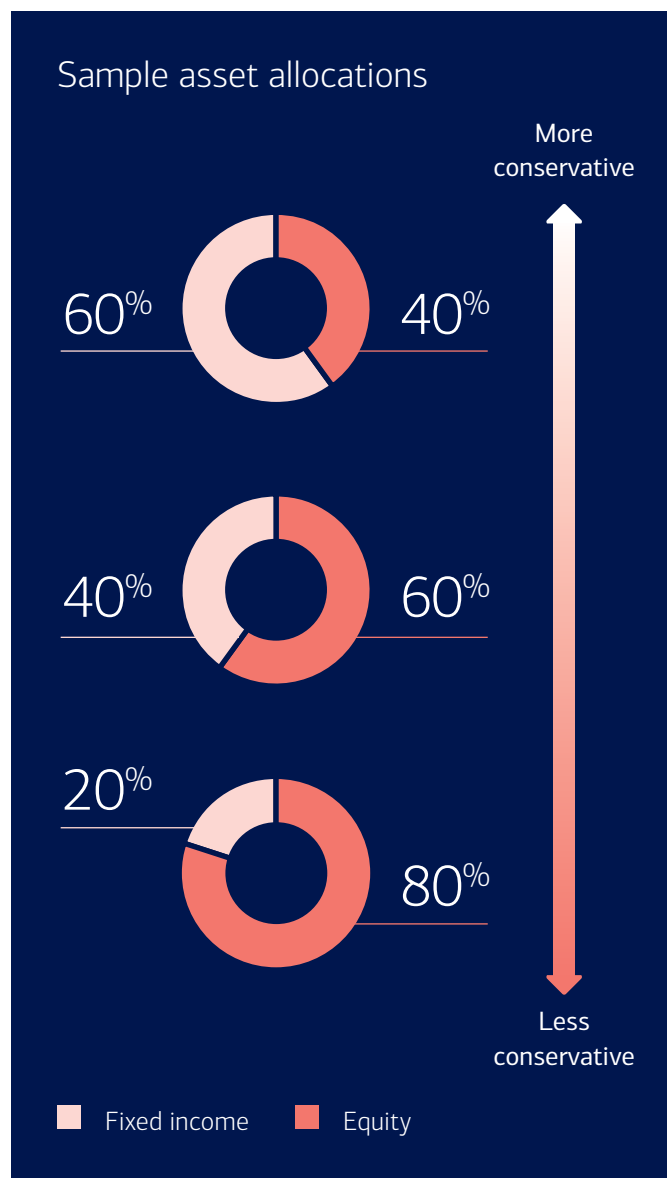
Market-based cash balance designs

For a market-based CB plan, there's a more natural hedge between assets and liabilities. Whether plan assets are invested more aggressively or more conservatively, the plan assets and participant account balances will mostly move together. Plan participants may benefit, in the long run, from having their interest accruals partially tied to equity returns rather than government bond yields, since equities tend to outperform bonds over longer time horizons. In a market-based CB plan, this is generally accomplished without subjecting the plan sponsor to significant funded status risk — a win-win.

There are some important caveats to the asset-liability matching described above for market-based CB plans which mostly become problematic in very poor market scenarios (e.g., equity market drawdowns). For example, under the Preservation of Capital rule, an asset allocation that is too aggressive may bring asset losses that are not matched by declines in participant account values, creating an asset-liability mismatch. The asset allocation should be conservative enough that achieving a negative return over a 5–10 year period becomes very unlikely. Some plan sponsors may also wish to provide participants with a higher guaranteed year-by-year floor on the interest crediting rate.

A cap on the interest crediting rate (ICR) may be considered if needed to comply with certain IRS plan rules. Caps on the ICR can present a different kind of asset mismatch — one

whereby an asset surplus may be created if asset returns exceed the granted interest crediting rate. The tighter the range of allowable interest crediting rates imposed by floors and caps, the more the plan will function like a fixed rate CB plan rather than a market-based design. These plan designs can potentially support the construction of more conservative asset allocations to achieve more stable expected returns.



The Preservation of Capital rule effectively imposes a floor interest crediting rate of 0% (not year by year but through a participant's entire benefit accrual period).

Alternative asset considerations

Alternative assets can potentially play a role in a CB plan's asset allocation, though riskiness and liquidity are important considerations. With most CB designs, there will be a desire for balancing the level and stability of investment returns. Higher returns are certainly desirable if achievable, but consistency is arguably even more important — especially with fixed or Treasury-based return targets. Alternative assets can potentially provide another source of growth with differentiated risk-return drivers from equities, which can increase diversification and reduce portfolio-level risk for a given return target. Again, liquidity is a very important consideration for CB plans since large lump sums are generally available to plan participants. This will limit the types and amount of alternative assets that are included in a CB plan's investment portfolio.

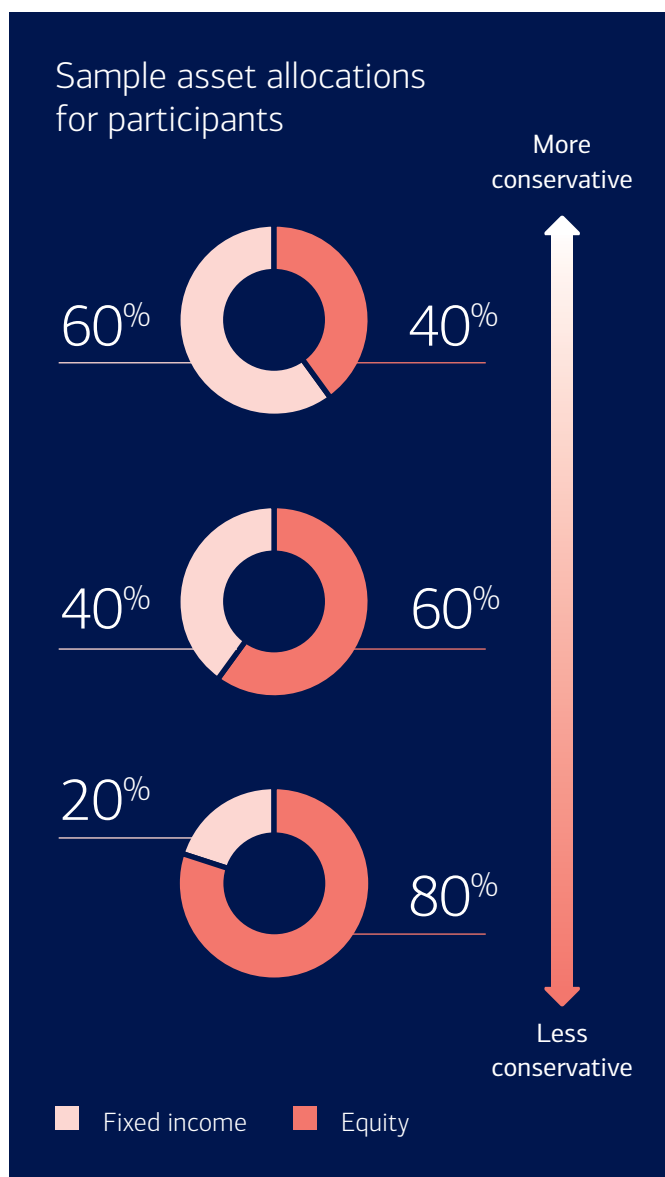
Participant choice

Incorporating participant choice into CB plans can potentially help align investment outcomes with participant preferences, but it introduces significant complexity and regulatory considerations that plan sponsors must address carefully. CB plans that provide participants with some options around the applicable interest crediting rate exist in the market, though they aren't commonplace. Regulatory guidance around these types of plan designs is limited, so plan sponsors should exercise caution and involve employee benefits counsel early if considering them.

Beyond the regulatory concerns, allowing participants to select asset allocation options adds layers of complexity to plan administration and the investment of plan assets. To maintain operational feasibility, sponsors typically impose strict limits on both the number of allocation options and the frequency of changes. For example, a plan might offer three allocation mixes (e.g., 60/40, 40/60, 20/80) and allow changes only during an annual election window. While this approach provides more flexibility than offering participants no choice at all, it is far more restrictive than a typical DC plan. Limiting changes to an annual window also reduces the administrative burden of rebalancing plan assets (as opposed to a design that allows for more frequent rebalancing), but plan sponsors should weigh whether this cadence is prudent given market volatility and ERISA fiduciary obligations.

Plan sponsors also need to consider the Preservation of Capital rule. Offering overly aggressive allocations could expose the plan to funding shortfalls if negative returns occur during accrual periods. Unless the plan sponsor is prepared to make additional contributions to offset losses, such options may not be advisable.

Additionally, allowing for participant choice can complicate nondiscrimination testing and other compliance requirements. Plan sponsors should involve employee benefits counsel in the design process and on an ongoing basis to evaluate potential regulatory pitfalls and confirm that the plan remains compliant under all applicable rules.



Offering cash balance plans with DC plans

Offering a CB benefit in concert with a DC plan, like a 401(k), can potentially provide a robust overall retirement package for employees. Each plan can offer distinct advantages: A DC plan generally provides more optionality for participants, while a CB plan provides a more stable guaranteed benefit.

A 401(k) DC plan allows for employee contributions and gives participants the opportunity to direct the investments in their plan accounts, enabling them to control their savings rate towards retirement, while offering flexibility in constructing an asset allocation aligned with individual risk tolerance and objectives. In contrast, a CB plan offers some of the benefits associated with traditional defined benefit plans, including the participant option of lifetime retirement income. When offered simultaneously, plan sponsors could tailor the construction of each plan to complement the other, though fiduciary decisions would have to be made for each plan independently.

Participant communications and education can help participants understand the plan designs and potential benefits and risks of both plan structures to assist them in making informed, holistic retirement plan decisions. The CB plan's design — particularly the plan sponsor's choice of interest crediting rate — can significantly impact the CB plan's risk/return characteristics and may affect the participant's ability to achieve their desired aggregate asset allocation and risk level across retirement assets.

Plan sponsors may also want to consider how the existence of a CB plan interacts with the development of the investment menu, including target date funds (TDFs), within a DC plan, recognizing that any fiduciary decisions for the DC plan must be made independently and solely in the best interest of DC plan participants and beneficiaries. In evaluating and designing TDFs, fiduciaries may consider relevant participant

demographics and characteristics as part of a prudent, plan-specific investment analysis. This may include generally observable participant circumstances, such as the existence of a broadly available source of retirement income, provided that any resulting investment decisions are supportable on a standalone DC plan basis and do not rely on or assume outcomes from any other income sources.

When applied appropriately with the support of an investment advisor, this analysis may support reasonable variation in TDF glidepaths relative to industry norms when a cash balance plan is available as a reliable source of post-retirement income. Fiduciaries should ensure that all assumptions, decision-making processes and conclusions are well documented and clearly grounded in the interests of the DC plan alone to maintain appropriate separation of fiduciary responsibilities and avoid any implication that investment risk is being offset or shared across plans.

Here are some key takeaways for sponsors of CB and DC plans:

- Participants may not understand how to consider integrating CB benefits into their long-term retirement strategy.
- Participant communications and investment education can assist participants in understanding the considerations regarding integrating CB benefits when evaluating their overall risk profile.
- Working with an investment advisor, plan sponsors can evaluate whether the DC plan design — including TDF glidepaths — takes into consideration the presence of a CB plan, while maintaining independent fiduciary oversight.

Plan design transitions

Changing the interest crediting rate in a CB plan is permissible, even if it's frozen, but it will involve legal, regulatory and practical considerations. Any transition must comply with ERISA and related IRS guidance, and it will generally necessitate updates to the plan document, nondiscrimination testing and other procedural steps. Accordingly, employee benefits counsel should be consulted, as appropriate.

As discussed above, it's important for plan sponsors and investment fiduciaries to understand the interactions between a CB plan's interest crediting rate and investment strategies before adopting a new plan design. Knowing this, a change to the interest crediting rate may warrant adjustments to the plan's underlying investment strategy to maintain alignment between plan obligations and asset performance.

Support from SECURE 2.0

For plan sponsors considering changes to the design of their pension or CB plan, the SECURE 2.0 Act of 2022 provides some flexibility and clarity. Additionally, this legislation provides more regulatory certainty for plan sponsors who offer market-based CB plans.

Here are some key provisions related to CB plans from Section 348 of SECURE 2.0 and associated guidance, including IRS Notice 2024-2:

- **Transition relief for changes to ICRs:** SECURE 2.0 clarifies that certain amendments to interest crediting rates can be made prospectively without violating ERISA's anti-cutback rules, provided specific conditions are met. In general, plan sponsors may eliminate a fixed minimum rate or move from a fixed rate to a permitted variable market-based rate for future interest crediting periods, so long as participants' current account balances are not reduced. Any amendment that reduces the rate of future benefit accruals will still require an ERISA §204(h) notice. Also, note that in most cases, this anti-cutback relief expires December 31, 2026.
- **Market rate of return flexibility:** Prior to SECURE 2.0, CB plans faced significant constraints on using interest crediting rates that exceeded a "reasonable market rate of return," a standard that was sometimes viewed as unclear in practice. As a result, market-based designs, particularly when combined with age- or service-graded pay credits, were problematic due to IRS anti-backloading concerns under IRC §411(b). SECURE 2.0 and its implementing guidance (IRS Notice 2024-2) provided welcome clarity and flexibility for defining the "market rate of return" to explicitly allow for interest crediting rates tied to plan investment returns (still subject to the Preservation of Capital rule).

Conclusion

CB plans offer opportunities for plan sponsors either as an individual plan or within a broader benefits and retirement plan offering. Plan sponsors can customize how credits are granted to plan participants and how interest is credited on the accounts over time, based on their objectives (and subject to IRS regulations). In doing so, they should be cognizant of the interactions between how the liabilities may evolve over time and how plan assets will correspondingly grow under various market scenarios. Providing interest crediting that is explicitly linked to investment performance

through a market-based design may be attractive for plan sponsors looking to manage balance sheet volatility without employing an overly conservative investment approach.



If you're interested in learning more about cash balance plans and supporting investment strategies, please reach out to us at Pension@bofa.com.

Intended for plan sponsor and consultant use.

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This article is designed to provide general information for plan fiduciaries to assist with planning strategies for their retirement plan and is for discussion purposes only. Always consult with your independent actuary, attorney and/or tax advisor before making any changes to your plan.

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