A Modern Defined Benefit Plan

Why a market-return cash balance plan might be the right design to improve sponsor and participant outcomes

Although defined contribution (DC) plans include many great features—including flexibility, ease of understanding and stable sponsor costs—many plan sponsors and policymakers, recognizing the shortcomings of a DC-only retirement program, have been seeking ways to reintroduce defined benefit (DB) plan features into DC plans. Two executives from actuarial and consulting firm October Three, Jeff Stevenson, president and CEO, and Larry Sher, partner, spoke with PLANSPONSOR about a more natural and comprehensive solution built on an existing DB design that they call a "market-return" cash balance plan, or the 'Modern DB' plan.

Jeff Stevenson

Larry Sher

PS: What do we mean by market-return cash balance plan?

Sher: It's a lot like a DC plan, even more so than a typical cash balance (CB) plan. Participants have an account balance, but like all cash balance plans it's a notional account balance. Benefits are expressed as account balances, pay credits, which are analogous to employer contributions in DC plan, are deposited periodically into accounts, and interest credits, which are analogous to investment returns, are credited. What distinguishes it from a traditionally-designed cash balance plan is that the interest credits are based on real market rates of return rather than bond yields.

PS: Which particular market returns are credited to these accounts?

Sher: There's quite a bit of flexibility in terms of how one might credit a market rate of return. That would be the employer's choice in designing the plan. The simplest approach would be to just credit the actual return on the pension plan's assets each year, whether positive or negative. For example, in a given year, if the return on the plan's assets is 8%, then all account balances would grow by 8%. There is one exception: when an individual is about to take money out of the plan or start an annuity, the account balance cannot be less than the sum of the employer pay credits. The return can fall below zero in a given year, but cumulatively it can't be below zero.

Plan sponsors could segment the asset returns if they don't want to include certain assets in this calculation, and they can use other types of returns. For example, the plan could specify a mutual fund as the basis to develop the interest credits under the plan.

PS: How does this plan design help stabilize sponsor costs?

Stevenson: Traditional DBs tend to have volatile and unpredictable plan contributions and accounting costs. If the stock market is down one year, or interest rates fall, required sponsor contributions and accounting costs will likely rise. When the market is up or interest rates rise, they can contribute less and enjoy lower accounting costs.

Even a traditionally-designed cash balance plan is susceptible to financial instability because the plan's assets and participant account balances will be out of sync. But, in a market-return cash balance plan stability is achieved because the plan's assets and participant account balances will move in tandem. That is assets and liabilities will be "in-sync."

PS: If cost stability is a goal, why not just offer a standard DC plan?

Sher: Lots of reasons, actually. Unlike DC-only programs, a market-return cash balance plan in combination with a 401(k) plan provides broader coverage of employees; leverages institutional investment expertise to produce better returns; allows for true "risk-sharing" between employers and employees, and provides greater flexibility to employers transitioning from a traditionally designed DB plan. Broader coverage is achieved by not requiring employee contributions to earn plan benefits. Surveys reveal that institutional investments achieve 1% or more annual returns than participant-directed investments.

A market-return cash balance plan also promotes retirement savings by precluding access to the balances during employment—no hardship withdrawals or loans. Like all DB plans, longevity protection is provided in retirement. It is not only possible for market-return cash balance plans to provide life annuity options—they must be offered. Life annuity payments typically are paid directly from the plan's assets, rather than purchased at retail prices from insurance companies. Of course, lump sums can also be offered.

A market-return cash balance plan shouldn't replace a defined contribution plan; they ought to work together. The core benefit would be the market-return cash balance plan, and then the DC benefit would supplement retirement income.

PS: What's the role of risk sharing?

Stevenson: Market-return cash balance plan designs can protect participants from extreme swings in account values, using floors—including the required cumulative 0% floor return—caps on returns credited to accounts, and sharing of returns. Participants are provided a combination of "downside protection" and "upside potential" that DC plans can't match.

Thus, not all risk is shifted to employees, as is the case in a DC plan, and not all risk is being taken on by the employer, which is the case in a traditionally-designed DB plan and, to a great extent, in a typical cash balance plan. This allows for a balancing, a sharing of risks and opportunities between employers and employees in a sensible way. For example, the employer can say, "In exchange for a 3% cumulative annual return, you will be credited 90% of the return each year." There are dials the employer can play with to achieve the degree of risk/opportunity sharing it desires.

PS: How can this design help plan sponsors transition from a traditional DB plan?

Sher: One of the issues that seems to be arising all the time with employers who had frozen their traditional DB plans is they were under the impression that the freeze was going to quickly alleviate the risks that were present with that plan. By freezing the plan, nothing is achieved in the short run—because the frozen plan's assets and liabilities are still not in sync. The assets are jumping around and changing as market values change, and the liabilities are changing as interest rates change. So, the DB plan is frozen, but not forgotten. Various strategies have been applied to, over time, achieve financial stability, but all of them necessarily involve throwing more money into the pot—either directly or indirectly through shifting plan assets to more conservative investments.

Instead of freezing a traditionally-designed DB plan and adopting a DC-only approach, plan sponsors should consider converting to a market-return cash balance plan where, over time, the assets and liabilities will become 'in-sync' and produce a more stable outcome at less cost.

PS: Is administration of a market-return cash balance plan complex?

Stevenson: It doesn't have to be. The best way to administer these plans is on a daily basis, just like a DC plan. Our proprietary daily-valuation platform not only allocates returns daily, but also integrates with defined contribution platforms so that participants can see a holistic view of both the cash balance and DC plans. ■

Comparison of Retirement Plan Designs

	MRCB Plan	Typical CB Plan	Typical 401(k) DC Plan	Traditional DB Plan
Easily Understood Accounts	✓	✓	✓	✗
Automatic Plan Enrollment	✓	✓	✓	✓
Stable Employer Contributions/Expense	✓	✗	✓	✗
No Employee Required Contributions	✓	✓	✗	✓
No Employee Investment Elections	✓	✓	✗	✓
Shared Risk/Opportunity	✓	✗	✗	✗
Minimum Benefit	✓	✓	✗	✓
No In-service Leakage (e.g., Loans)	✓	✓	✗	✓
Portable Lump Sum Option	✓	✓	✓	✗
Life Annuity Options	✓	✓	✗	✓