CONSENSUS PROPOSALS FOR PENSION FUNDING, PBGC REFORM, AND HYBRID PENSION PLANS

MAY 2005

THE ERISA INDUSTRY COMMITTEE

Representing the Employee Benefits Interests of America's Largest Employers

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ADVOCATING THE BENEFIT AND COMPENSATION INTERESTS OF AMERICA'S MAJOR EMPLOYERS

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EXECUTIVE SUMMARY

THE CURRENT DEBATE

Current policy discussions regarding defined benefit pension plans typically focus on perceived financial vulnerabilities of the Pension Benefit Guaranty Corporation (PBGC – the agency that guarantees pension payments from failed plans), on allegations that defined benefit pension plans are today seriously underfunded, and on the declining number of plans being offered.

- Private sector defined benefit pension plans pay approximately $110-120 billion in benefits to retirees every year. By comparison, the PBGC in 2004 paid just over $3 billion in benefits, or 2.6% as much. Over 44 million Americans receive benefits from defined benefit plans or will receive benefits in the future. By comparison, the PBGC's present and future benefit population was 1.06 million at the end of 2004, or 2.4% as large a group. Moreover, in 2004, the PBGC received approximately $1.5 billion in premium payments and earned $3.2 billion by investing its assets. The PBGC does not face a liquidity crisis, and it is clear that the critical focus of the retirement security debate is maintaining a vibrant, attractive, and healthy defined benefit pension system.

- The funded status of defined benefit plans cannot be gauged on a short-term basis. Assets in private sector defined benefit plans totaled $2.056 trillion at the end of 1999, dropped to $1.531 trillion at the end of 2002, but climbed back to$1.8 trillion by the end of 2004. Moreover, the interest rate for calculating current liabilities, which was 7.17% for 1998, is 6.1% for 2005. If interest rates rise by 100 basis points, current liability calculations will decrease by $200 billion.

- Defined benefit plans are a very cost effective way to provide real retirement income to workers. Because both the risk of investment loss and longevity risk are pooled, larger benefits can be provided for less cost. Large income means greater retirement security. Thus, employers and employees both will continue to seek these plans. By clarifying the status of hybrid plans and by providing a sound regulatory framework that encourages employers to establish and continue plans, recent declines in the numbers of defined benefit plans can be brought to a halt and perhaps reversed.

From its beginning in 1975 through the end of 2003, the PBGC has assumed responsibility for 3,277 plans. Over that same period, 164,000 plans – or 50 times as many – terminated fully funded and without imposing any obligation on the PBGC. The vast majority of plans are not a threat to the PBGC – but harsh and volatile rules are a threat to the vast majority of plans and to the businesses that sponsor them. Unfortunately, many aspects of the Administration's proposals, if enacted, would hinder the continuation and establishment of pension plans.

ERIC PROPOSALS

Some issues that have come to the surface in recent years deserve serious consideration and positive action. To address these issues, ERIC urges the following actions.

Regarding contributions that plan sponsors are required to make to their pension plans:

1. Enact a permanent interest rate to calculate current liabilities.
2. Retain the long-term ERISA funding rules, but reduce the amortization period for plan amendments that increase benefits from 30 years to 10 years.
3. Retain present law averaging of current liability interest rates and plan assets.
4. Enact the present-law composite corporate bond rate as the permanent interest rate for the short-term (current liability) funding rules.
5. Include lump sums in the current liability calculation.
6. Apply the permanent composite corporate bond interest rate to calculate the minimum lump sum amount, after an appropriate phase-in.
7. Reject the Administration's proposal to provide different rules based on a company's credit rating.
8. Accelerate funding any time the plan is less than 90% funded.
9. Retain credit balances, with modifications.
10. If plan-specific interest rates are mandated, also allow plan-specific mortality assumptions.

Regarding contributions plan sponsors are permitted to make to their plans:

1. Enact the modifications to defined benefit plan funding and benefit limits included in EGTRRA on a permanent basis.
2. Allow deductible contributions to be made up to 130% of current liability, and, in addition, allow deductible funding above 130% of current liability for future salary and benefit increases.
3. Repeal the 25% of compensation limit for Title IV plans.
4. Eliminate the 10% excise tax on nondeductible contributions.
5. Allow pension plans to fund savings plan contributions on behalf of the pension plan's participants.

Regarding the solvency of the Pension Benefit Guaranty Corporation:

1. Reject the Administration's proposed increases in the PBGC premiums.
2. Treat shut-down benefits as a plan amendment for funding and guarantee purposes as of the date they are triggered. Also, apply to shut-down benefits the restrictions under present law and proposed below that apply to payment of lump sums.
3. Freeze the benefit the PBGC will guarantee at the time of bankruptcy.
4. Prohibit amendments that increase benefits if the plan is less than 70% funded and has been less than 100% funded for more than a year.
5. If the plan sponsor is in bankruptcy, limit the percentage of any lump sum.
6. Retain present law prohibitions on benefit amendments in bankruptcy as well as on lump sums and other accelerated forms of benefit payments in the case of a plan with a liquidity shortfall.
7. Encourage employees to opt for annuity payout forms by (a) conforming the interest rate applicable to lump sums to the corporate rate used for funding; and (b) providing tax incentives for annuity payments from qualified plans.
8. Provide for greater flexibility in developing solutions for specific industries that will

increase the likelihood that companies will be able to restructure their enterprise and avoid distress terminations of their pension plans.

Regarding disclosure:

1. Provide participants annually with a statement of the plan's funded status based on timely information currently available – such as information on plans compiled for SFAS 87 disclosure.
2. Replace the SAR with the report described above.

Regarding hybrid defined benefit pension plans:

1. Confirm, both retroactively and prospectively, that plans that recognize the time value of money, such as cash balance, pension equity, contributory defined benefit, indexed career pay, and variable annuity plans, are not age discriminatory.
2. Provide that a conversion of a traditional plan to a hybrid plan would comply with the age discrimination requirements if (a) neither the old benefit formula nor the new benefit formula discriminated on its face on the basis of age, and (b) the conversion did not violate the anti-cutback rule in effect on the date of the conversion.
3. Eliminate whipsaw both prospectively and retroactively (excluding cases that have been finally resolved).
4. Provide that if a plan provides participants with the benefit produced by two or more alternative formulas, the plan will comply with the anti-backloading rules (on both a prospective and retroactive basis) if each of the formulas, tested separately, complies with those rules.
5. Clarify, both prospectively and retroactively, that if a plan provides for an offset for benefits provided by another plan, the plan will comply with the anti-backloading rules if the gross benefit formula complies with these rules.
6. Direct the Treasury not to revisit the nondiscrimination testing issue raised by the proposed and 401(a)(4) regulations that Treasury has withdrawn.
7. Direct the Treasury to begin issuing, by a date certain, determination letters to plans that have been converted from traditional designs to hybrid designs.

CONCLUSION

As the PBGC has stated, the agency faces potential long-term issues but does not face a liquidity crisis. It has on hand sufficient assets to pay trusteed benefits for many years into the future. Moreover, when it trustees a plan, its asset base grows. Unfortunately, PBGC is locking in current deficit projections by transferring its investments to bonds and fixed income, and the Administration is proposing that the entire projected PBGC deficit be paid off by plan sponsors over the next ten years or less.

This self-defeating approach to PBGC security is compounded by the Administration's proposals to impose volatile and overly expensive funding requirements on all plans and to impose an expansive definition of liability as well as harsh benefit and guarantee restrictions on the plans of any company that drops below investment grade. At a minimum, the Administration's proposals are a strong incentive for employers not to sponsor defined benefit plans in the future, further weakening, not strengthening, the PBGC's future prospects. More importantly, the Administration's proposal will weaken the retirement security of future retirees just as the baby boom is reaching critical ages. If the proposals are enacted, millions of workers will enter retirement with less money.

Actions such as those recommended by ERIC should be taken to improve the function and security of defined benefit plans while also protecting the PBGC against unreasonable losses.

ERIC

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CONSENSUS PROPOSALS FOR PENSION FUNDING AND PBGC REFORM

THE ROLE OF PRIVATE SECTOR DEFINED BENEFIT PENSION PLANS

The Current Debate:

Current policy discussions regarding defined benefit pension plans typically focus on the declining number of plans being offered, on allegations that defined benefit pension plans are today seriously underfunded, and on perceived financial vulnerabilities of the Pension Benefit Guaranty Corporation (PBGC). None of these focuses provides a full and accurate picture of how defined benefit plans today provide substantial retirement income security to millions of current and former American workers and their families. Nor do they address the potential role of defined benefit plans in meeting the future retirement needs of the nation's workers.

Consider the following facts:

- In 2004, 42% of all private sector workers who participated in an employer-sponsored retirement plan participated in a defined benefit pension plan. Whether these approximately 20 million plan participants who are still working will continue to build credit toward a secure retirement – or whether they will have substantially less money when they retire – depends on whether Congress creates a regulatory scheme that encourages employers to maintain their defined benefit plans in the future. [BLS, National Compensation Survey, March 2004, table 2; EBRI Frequently Asked Questions About Benefits – Retirement Issues: Active Participant Trends, www.ebri.org/benfaq]

- Approximately one-half of today's retirees age 55 and older receive pension income from a former employer or from a spouse's former employer. Additional numbers of retirees receive a lump sum payment from their employer's pension plan. Unless defined benefit plans flourish in the future, more individuals will reach retirement with less money available to them, dramatically increasing pressure on the social security system. [EBRI FAQs: How many retirees receive work-related pensions?]

- All workers with access to a defined benefit plan participate in the plan. Despite sometimes heroic efforts on the part of plan sponsors, not all employees with access to a defined contribution plan participate; in fact, 21% do not. Encouraging greater numbers of defined benefit plans in the future will help to fill the participation gap, ensuring larger amounts of retirement income for millions of workers. [BLS, National Comp Survey, above, tables 1 & 2]

- The Administration has focused on the status and future of the Pension Benefit Guaranty Corporation (PBGC), but:

  - Private sector defined benefit pension plans pay approximately $110-120 billion in benefits to retirees every year. By comparison, the Pension Benefit Guaranty Corporation in 2004 paid just over $3 billion in benefits, or 2.6% as much. [Cerulli Assoc, Quantative Update, Retirement Markets 2004; PBGC 2004 Annual Report, p. 2]

  - Over 44 million Americans receive benefits from defined benefit plans or will receive benefits in the future. By comparison, the PBGC's present and future benefit population was 1.06 million at the end of 2004, or 2.4% as large a group. [PBGC 2004 Annual Report, pp. 13 & 2]

  - The PBGC reports that over the next several years the agency could possibly assume responsibility for plans with total unfunded liabilities of as much as $96 billion. But PBGC-insured private sector defined benefit plans carry $1.33 trillion in funded and unfunded liabilities. The PBGC's maximum possible exposure represents 7% of the defined benefit system. [PBGC 2004 Annual Report, p. 33; PBGC 2003 Data Book, Table S-40]

  - *Clearly, for the retirement security of American workers, the critical focus of any retirement policy debate is not the PBGC but maintaining a vibrant, attractive, and healthy defined benefit pension system.*

- The funded status of defined benefit plans cannot be gauged on a short-term basis. Private sector defined benefit plans held $2.058 trillion in assets at the end of 1999. Asset values dropped to $1.531 trillion at the end of 2002 but climbed back up to $1.8 by the end of 2004. In the future, as asset values climb and as corporate bond interest rates increase (reducing liability calculations), the funded status of pension plans will improve on its own. Moreover, the maximum allowable mandated interest rate for calculating liabilities dropped from 7.17% for 1998 to 6.21% for 2001, sharply increasing liability calculations, and is 6.1% for 2005. If interest rates rise by 100 basis points, current liability estimates will decrease by approximately $200 billion. [Cerulli Assoc., above; Federal Flow of Funds]

- Even before additional economic recovery, the vast majority of plans are well funded. In the aggregate, companies in the S&P 500 were 89% funded at the end of 2003 on a GAAP basis, including major airline plans. A study of the 100 largest plans indicates at the end of 2004 the tax-qualified plans sponsored by these companies plans were well over 98% funded on an accumulated benefit obligation (ABO) basis. The 98% calculation substantially understates the status of funding for the tax-qualified plans that are the focus of the current debate because it also includes benefits under nonqualified deferred compensation plans and foreign plans which are often not funded and are not guaranteed by the PBGC. [Goldman Sachs: Pension Reform, April 6, 2005; Milliman 2005 Pension Study, April 12, 2005.]

- From its beginning in 1975 through the end of 2003, the PBGC had assumed responsibility for 3,277 plans with unfunded liabilities. Over that same period, 164,000 plans – or 50 times as many plans – terminated fully funded and without imposing any obligation on the PBGC. The vast majority of plans are not a threat to the PBGC – but harsh and volatile rules are a threat to the vast majority of plans and the businesses that sponsor them. [PBGC Pension Insurance Data Book: 2003, p. 27]

The Future Debate:

Defined benefit plans are a very cost effective way to provide real retirement income to workers. An individual saving for his or her own retirement must save enough to provide a realistic income plus additional amounts to cover the risk of investment losses as well as the risk that he or she will outlive their retirement assets. In a defined benefit plan, these risks are pooled. This means that the same benefit can be provided at much less cost – or, to put it another way, if you start with the same amount of money, larger benefits can be provided to individuals through a defined benefit program. Larger income means greater retirement security.

Employers will want to continue or establish defined benefit plans in the future. Before their legal status was called into question, many employers were turning to hybrid defined benefit plans such as cash balance plans that are well-suited for the modern workforce. Some of these employers had never sponsored a defined benefit plan before. Employees appreciate and need the certainty provided by defined benefit plans and their cost-effectiveness in providing higher benefits and will want their employers to sponsor these plans. By clarifying the legal status of hybrid plans and by providing a sound regulatory framework that encourages employers to establish and continue pension plans, recent declines in the numbers of defined benefit plans can be brought to a halt and perhaps reversed.

Unfortunately, many aspects of the Administration's proposal, if enacted, would hinder the continuation and establishment of plans.

WHAT ISSUES HAVE BEEN RAISED AND WHAT SHOULD BE DONE ABOUT THEM?

The Administration has painted a dire picture of the future of defined benefit plans and has backed that picture with a series of harsh and far-reaching proposals. The danger is that, despite the present health and vitality of the vast majority of defined benefit plans, enactment of the Administration's proposals will create a self-fulfilling prophecy. A regulatory scheme that is too harsh, too volatile, and that penalizes companies who sponsor defined benefit plans will have the obvious effect of driving employers away from these types of plans. In some instances, the Administration's proposals could even have the effect of pushing the company itself out of business. If these results are allowed to happen, millions of Americans will approach retirement with less ability to maintain a reasonable living standard.

We agree with the Administration that the laws affecting defined benefit plans should be modified in various respects. However, we clearly differ with the Administration on the design and specifics of many of those suggested modifications. Some issues that have come to the surface in recent years deserve serious consideration and positive action. But those issues should be addressed only through balanced and effective proposals, such as those outlined below, that will add to the future security and vitality of defined benefit plans.

In its February 7, 2005, proposal, "Strengthening Funding for Single-Employer Pension Plans" (see www.dol.gov/ebsa), the Administration identifies several areas where it sees problems with the current rules governing defined benefit plans. Those areas are addressed below, along with, where appropriate, ERIC's proposals to address them.

A. PROPOSALS REGARDING REQUIRED CONTRIBUTIONS.

The Administration asserts that "current measures of plan funding are not based on measures of assets and liabilities that are meaningful and accurate."

To address this concern, the Administration proposes to:

- enact a permanent mandated interest rate to calculate liabilities;
- eliminate the current long-term funding rules;
- impose a single, short-term funding rule based on a near-spot measure of liabilities in the form of a corporate bond yield curve and a spot measure of assets;
- apply the yield curve to lump sum distributions;
- require companies whose credit rating is below investment grade to fund their plans as though they were about to terminate;
- accelerate funding any time the plan is less than 100% funded on a short-term basis;
- require any unfunded amount, including that related to plan amendments, to be amortized over seven years; and
- eliminate the ability of a plan sponsor to receive credit if it pre-pays future obligations.

ERIC proposes that Congress:

1. **Enact a permanent interest rate to calculate current liabilities.** Without action, the 30-year Treasury bond, which was discontinued on October 31, 2001, will be imposed as the mandated rate beginning January 2006.

2. **Retain the long-term ERISA funding rules with modifications. Specifically, reduce the amortization period for plan amendments that increase benefits from the 30 years under present law to 10 years.**

3. **Retain present law averaging of rates and assets.** Under present law, the current liability interest rate is based upon a weighted four-year average, with the most recent years carrying the most weight. Sponsors may use a rate between 90% and 100% of this average. Assets may be averaged over five years – but the resulting amount must be between 80% and 120% of the fair market value of the plan's assets.

4. **Enact the present-law composite corporate bond rate as the permanent interest rate for the short-term (current liability) funding rules.**

5. **Provide a more accurate measure of liabilities by including lump sums in the current liability calculation.** Override the IRS notice that excludes the subsidized value of lump sum distributions from the calculation of current liability.

6. **Apply the permanent composite corporate bond rate to calculate the minimum lump sum, after an appropriate phase-in.** The amendment should also accommodate plans that, under current law, rely on rates other than the 30-year bond rate for the calculation of lump sums.

7. **Reject the Administration's proposal to provide different rules based on a company's credit rating.**

8. **Accelerate funding any time the plan is less than 90% funded.** Under present law accelerated funding does not apply unless a plan is less than 90% funded for two of the last three years. Under the proposal, deficit reduction contribution (DRC) payments would commence in any year in which the plan's funded status has fallen below 90%.

9. **Retain credit balances, with modifications.**

10. **If provision is made for plan-specific interest rates under current liability funding requirements, then plan-specific mortality assumptions also should be allowed.**

Discussion:

1. Enact a permanent interest rate to calculate current liabilities.

We applaud the Administration's recognition of the need for a permanent discount rate. In 1987, the 30-year Treasury bond was selected as basis for the mandated interest rate in the current liability (short-term) funding rules. That bond was discontinued on October 31, 2001.

Few circumstances have caused more confusion and created a greater impediment to employers maintaining defined benefit plans than the lack of a permanent discount rate. The uncertainty concerning the appropriate rate – and the potentially devastating gyrations in requirements to divert cash unnecessarily into the pension plan – has seriously disrupted business planning, causing many employers to freeze or even terminate their plans in order to restore their ability to plan their business investment.

Moreover, while a series of temporary "fixes" has allowed actual plan funding to go forward at rational levels, they have been enacted too late to accommodate business planning needs. Enactment of the mandated rate on a permanent basis will solve this problem.

2(a). Retain the long-term ERISA funding rules.

The long-term ERISA funding rules, first enacted in 1974, require funding for anticipated future benefits, provide for predictable and stable contributions compatible with business planning requirements, and for decades have resulted in the vast majority of plans being well-funded and paying all promised benefits to participants.

In 1987, short-term funding rules based on a plan's current liability were enacted as a backstop to the long-term ERISA rules. The short-term rules were modified in 1994. The predictable and stable long-term rules have been the predominant funding standard for most plan sponsors since 1974 even though present law short-term (current liability) funding rules have governed funding in many companies in the past few years during a period of market downturns and low interest rates.

Short-term measures of a plan's liabilities and assets are accurate only for the point in time measured. A spot rate is accurate – but only for that one day. It is not accurate for tomorrow or the next day or the next year. Pension plans are long-term obligations with long-term payout schedules. Spot measures actually provide a very unreliable picture of the plan's ability to meet its obligations over time.

The long-term rules enable a business to take on the obligation of a defined benefit pension plan within the context of business planning needs. Moreover, because changes in interest rates and realized investment results are recognized over time, the long-term rules can provide for a steady flow of contributions to a plan whether the economy is in a short-term period of high or low interest rates and favorable or unfavorable asset performance. Thus, for these and other reasons, these rules should not be scrapped unless and until a system of substantially equal predictability and stability is devised and phased in.

Unfortunately, in proposing short-term funding rules as the only rules, the Administration proposal not only fails to meet this need, it moves in the opposite direction.

Over time, the impact of the Administration's approach will be to have fewer and less well funded plans.

2(b). Reduce the amortization period for plan amendments that increase benefits from the 30 years under present law to 10 years.

Appropriate changes can and should be made to improve the ERISA long-term funding rules. Reducing the amortization period for plan amendments that increase benefits from the 30 years under present law to 10 years will significantly accelerate the funding of new or enhanced past service liabilities and thereby prevent deterioration of the plan's funded status over time, including where credit balances are present.

This simple change will be more effective in maintaining well-funded plans over the long run than the Administration's proposal to enact an entirely new funding regime where funding requirements can vary dramatically from year to year and may remain at very low levels for several years during periods of high interest rates.

3. Retain present law averaging of rates and assets.

First enacted in 1987 and revised in 1994, short-term current liability funding rules provide a backup to the long-term ERISA rules. They are designed to ensure that a plan maintains assets reasonably close to what would be needed to defease its current (not its future) liabilities. These rules (1) restrict the assumptions that can be used in calculating a plans funded status and (2) require an acceleration of contributions to plans that, under this measure, are persistently or significantly underfunded.

The present-law rules recognize, however, the need for predictability and stability in cash funding requirements as well as the impact of normal business cycles. During a recession, interest rates and/or asset values often decrease and the plan's funded status accordingly will dip temporarily. Thus, in calculating the plan's funded ratio, asset values and interest rates are averaged (albeit within strict corridors). Under this structure, (1) the plan sponsor has a few years' warning that the company may face a cash call due to required acceleration of contributions, and (2) employers typically are not asked to come up with that cash during a recession. Instead, the obligation will occur after the economy is back in an upswing.
Recent experience indicates that the present-law current liability rules are still too volatile for stable funding. Sharp gyrations in cash funding requirements nearly always result in additional numbers of plans being terminated or frozen. The past few years have been especially harsh. It is critical that funding reforms ensure that funding requirements work with the employer's need to plan its business operations and with the normal ebb and flow of economic cycles.

Unfortunately, the Administration proposal marches in precisely the opposite direction. The Administration would require that a plan's funding status be calculated using a near-spot interest rate and market value of assets. Under this scheme, the employer's ability to predict future cash calls will be obliterated, and contribution requirements will be far more volatile than under current law. Moreover, the Administration has proposed no workable mechanism to address either of these critical concerns that, if not addressed, would severely impact the ability of employers to sponsor defined benefit pension plans.

Because it will exacerbate downswings in the economy by diverting large amounts of cash from business pursuits, the absence of averaging also would have a deleterious impact on jobs. Research has shown that if the Administration's scheme had been in place in 2003, it would have cost more than 300,000 jobs. [Business Roundtable: "Pension Smoothing Changes Would Worsen Job Losses in Recession", 2/28/2005]

Administration officials have suggested that plans could insulate themselves against the additional volatility caused by their proposal by reducing their equity exposure and investing a greater portion of the plan's assets in bonds. There are two serious flaws in this thinking. First is that, since bonds over time provide less return than equities, the plan will not be able to sustain the same level of benefits. Future retirees will retire with less money. It does not seem to make much sense to make plans more expensive and less generous just as the baby boom cohort is beginning to retire. Secondly, the Administration's proposed rate is a "near" spot rate, a rate that is in fact averaged over about four and a half months. Instruments do not currently exist in the market that would provide a true match for a "near" spot rate. Thus plan sponsors would still be faced with volatility problems.

The overall result of the Administration's approach will be that many employers will be forced to freeze or terminate their plans. Imposing rules that result in plans being frozen or terminated does not result in better funding – it results in no funding and no future benefit accruals. Many individuals will needlessly face retirement with less money. Such a solution does not comport with sound public policy.

4. Enact the present-law composite corporate bond rate as the permanent interest rate for the short-term (current liability) funding rules.

The composite corporate bond rate enacted for 2004 and 2005 approximates the amounts needed to defease liabilities under pension plans. It is working well, easily understood by plan sponsors and policy officials, not complicated, transparent, free from manipulation, and easy to enforce.

Imposition of the Administration's proposed corporate bond yield curve would, on the other hand, be a mistake. Consider the following:

- The yield curve is unnecessarily complex in application since even very mature pension plans still have long durations because their payments to retirees are made over years, and typically over decades. If Congress chooses to require more precision regarding the duration of plan liabilities, it can do so in ways that are far simpler and more transparent.
- Use of a yield curve also will <u>compound</u> the volatility of contribution requirements since both the interest rate and the curve itself will fluctuate.
- In addition, a yield curve is not a suitable rate for calculation of lump sums because it will be difficult to explain to participants, more complicated to administer, and, because the lump sum amount is interest sensitive, may not appropriately reflect the duration of these benefit commitments.
- Nor is the yield curve an appropriate rate for several of the approximately one dozen other provisions of law that rely on the current liability

rate – none of which are addressed by the Administration.

- While the Administration proposal calls for interest rates theoretically tailored to each plan's expected payout in the name of accuracy, it still requires all plans to use the same mortality tables, creating for some plans a substantial imbalance of assumptions.
- Finally, the proposed yield curve, to be constructed by Treasury staff, represents an enormous transfer of authority from Congress and from the markets to agency staff. The construction of the yield curve is opaque and difficult to oversee and its accuracy is questionable since available markets in the sections of the curve that are most critical to most pension plans are thin, requiring the staff to interpolate interest rates at those points. Moreover, the staff must extrapolate rates for periods beyond thirty years where there are essentially few, if any, bond yields to available. In essence, under the Administration's proposed yield curve it will be the government, not the capital markets, that define "market based" liabilities of pension plans.

5. Provide a more accurate measure of liabilities by including lump sums in the current liability calculation.

As part of its argument that funding rules achieve greater precision regarding the pattern of future payments of benefits, the Administration accurately registers concern that distributions of lump sums can rapidly diminish a plan's short-term funded status. It is not necessary to rewrite all of the funding rules to address this problem. It can instead be addressed by overriding, with an appropriate phase in, IRS Notice 90-11, which excludes the value of lump sum distributions from the calculation of current liability. Payment patterns involving lump sums are already taken into account in the long-term ERISA funding rules.

6. Apply the permanent composite corporate bond rate to calculate the minimum lump sum, after an appropriate phase-in.

We applaud the Administration's recommendation that the permanent short-term rate also be used to calculate the minimum lump sum amount – although we disagree with their proposal to use a yield curve for the permanent short-term rate and note that use of a yield curve is particularly unsuitable for lump sum calculations.

The minimum allowable lump sum currently is calculated using the discontinued 30-year bond. As a result the value of the lump sum is artificially inflated. This inappropriately encourages employees to turn down annuity payout options and can also result in the rapid depletion of a fund's assets if a significant percentage of employees leave over a short time period. A rate that is more neutral vis a vis annuity payout options and that does not undercut plan funding schemes must be enacted.

Combined with the previous recommendation to include lump sums in the current liability calculation, we note that this change, because it will encourage more employees to take their benefits in annuity form, will help address the concern that a plan's funded status might be depleted when a large number of employees leave over a short period of time.

Because it is necessary to prevent a "run on the bank" by employees who are already eligible to retire and who are naturally concerned about <u>any</u> change to their benefit calculations, such a change should be phased in over time.

The amendment should also provide for plans that, under current law, rely on rates other than the 30-year bond rate for the calculation of lump sums, including providing transition and 411(d)(6) relief for those plans that change to the new rate.

7. Reject the Administration's proposal to provide different rules based on a company's credit rating.

The Administration proposes that companies who fall below investment grade be required to fund their plans as though they were about to terminate. Many, many companies have been or will be below investment grade from time to time and will never terminate a plan that is trusteed to the PBGC. Use of a company's credit rating as a trigger for more stringent funding requirements is like an ineffective and harmful medical test that results in too many "false positives."

At a minimum, the proposal is a strong incentive for employers not to sponsor defined benefit plans in the future. Its very existence can cause some companies to be downgraded and make it more difficult for companies to climb back to a higher rating. The proposal will unnecessarily divert cash away from business needs for a large number of employers who otherwise are not likely to terminate their plans and make business recoveries more difficult. It can in some instances create a death spiral for a company that the funding rules should seek to avoid. The result will be more, not fewer plan terminations – a poor policy choice.

For companies without a credit rating, the proposal amounts to the government ruling, through regulations, on the financial soundness of a company – an unprecedented intrusion into the free market.

Finally, there are numerous concerns about how the credit rating agencies operate that are being explored both in Congressional committees and the Securities and Exchange Commission.

The proposal should be rejected in its entirety.

8. Accelerate funding any time a plan is less than 90% funded.

The Administration has expressed concerns that the funded status of a plan can deteriorate rapidly so that by the time it reaches the PBGC it is in much worse condition than it was even a few years before. We propose several changes that directly address that concern without resorting to the harsh and counterproductive measures proposed by the Administration. These ERIC proposals address various circumstances in which a plan's funded status can rapidly deteriorate:

- ✓ Reducing the amortization period for benefit improvements (#2 above),
- ✓ Including lump sums in the calculation of current liability (#5 above),
- ✓ Eliminating the current-law imbalance between the value of lump sum and annuity benefits (#4 above),
- ✓ Modifying the treatment of credit balances (discussed below),
- ✓ Allowing greater pre-payment of future obligations (discussed below), and
- ✓ Modifying the law concerning shut-down benefits, PBGC guarantees, plan amendments, and annuity payouts (discussed below).

In addition, we propose that accelerated funding would begin any time a plan is less than 90% funded, rather than the 80% trigger of current law. The rule that accelerated funding is required if a plan is less than 90% funded for two of the last three years also would be eliminated.

The PBGC is not threatened by a plan that is 90% funded. From 1975 through 2003, less than 3.3% of the dollar amount of PBGC claims came from plans funded at a 75% or higher level on a termination basis, and the PBGC had received <u>no</u> large claims (claims larger than $100 million) from plans funded at a 75% or higher level. [PBGC Pension Insurance Data Book 2003, p. 35]

On the other hand, it is entirely normal for a plan to drop to a current liability funded level in the 90's during economic downturns. These dips in funded status are indeed temporary, natural, and not a cause for alarm. With the changes ERIC is proposing to prevent rapid deterioration of the plan's funded status, there is no reason to impose additional burdens on a company whose a plan is funded at 90% or higher levels.

Imposing accelerated funding can dramatically increase the cash call on a company. DRC payments require funding of a plan's normal cost as well as a portion of any deficit; they also may result in a double payment in the first year – quarterly contributions for the current year as well as an annual contribution for the previous year. Accelerated funding should not be imposed unless absolutely necessary.

9. Retain credit balances, with modifications.

The Administration has proposed to abolish the ability of an employer to receive credit when it pre-pays future contributions. Thus an employer who pre-pays contributions will be in a worse economic position when new contributions come due than an employer who does not because the employer who pre-paid is still likely to be required to make additional contributions. This makes no sense. Discouraging pre-payments will result in more poorly funded plans and needlessly subject the PBGC to additional exposure.

Moreover, many businesses face cycles when they have extra cash followed by cycles when cash is scarce. They should be encouraged to pre-fund contributions during the up-cycles. Otherwise, subsequent funding requirements will exacerbate the down-cycles by diverting precious cash away from business recovery efforts.

The present law regarding credit balances should be modified, however. Under present law, the balance available to offset required contributions is not adjusted if the underlying value of the assets decreases through unfavorable investment performance. Carefully targeted and prospectively-applied reforms would address this concern.

An employer that pre-funds pension obligations is often shifting risk from the pension plan to shareholders and bondholders of the company. To be successful, a future credit balance structure must:

1. clearly facilitate a company's decision to pre-fund its pensions;
2. discourage the use of credit balances to avoid additional contributions when a plan is very severely underfunded, and
3. recognize that the rules should not be changed arbitrarily or retroactively for those who have current-law credit balances because they made a decision to pre-fund in the past.

10. If provision is made for plan-specific interest rates under current liability funding requirement, then plan-specific mortality assumptions also should be allowed.

If this is not done, liability measures for some plans will be substantially inaccurate. The Administration's proposals claim a high degree of precision in liability measures, but fail to apply that standard to all key measures of liability. Specifically, just as different plans may have more or fewer retirees per worker, which is taken into account in computing the plan's liability, different plans also have different mortality experience.

The more precise and plan-specific other measures of liability become, the more important it is also to be precise about mortality experience.

B. Proposals Regarding Permitted Funding

The Administration urges that "rules should provide employers with the opportunity for additional funding."

To address this concern, the Administration proposes to:

- make permanent the benefit and contribution limit increases included in EGTRRA;
- permit additional tax-deductible contributions up to 130% of accumulated liabilities plus projections of future salary and benefit increases.

ERIC proposes that Congress:

1. **Enact the modifications to defined benefit plan funding and benefit limits included in EGTRRA on a permanent basis.** (As in the Administration's budget.)

2. **Allow deductible contributions to be made up to 130% of current liability, and, in addition, allow deductible funding above 130% of current liability for future salary and benefit increases.** (Similar to the Administration's proposal.)

3. **Repeal the 25% of compensation limit for Title IV plans.**

4. **Eliminate the 10% excise tax on nondeductible contributions.**

5. **Allow pension plans to fund savings plan contributions on behalf of the pension plan's participants.**

Discussion:

1. Enact the modifications to defined benefit plan funding and benefit limits included in EGTRRA on a permanent basis.

Limitations on deductible contributions imposed as a result of deficit reduction efforts in the 1980s effectively truncated the ability of employers to fund for the impending retirement of the baby boom cohort. Amendments that imposed a cap on compensation that could be included in benefit calculations and that reduced the section 415 limits on benefits allowed under DB plans prevented plans from projecting – and funding for – the full amount of expected future benefits. In effect, at the same time the baby boom cohort was fully engaged in the workforce, the reduced limits delayed necessary funding until a later date. The results of those actions are being felt now. The modest uptick in these limits that were included in EGTRRA are a necessary first step in turning this trend around and in allowing companies to fund all of their obligations on a more regular and rational basis.

2. Allow deductible contributions to be made up to 130% of current liability, and, in addition, allow deductible funding above 130% of current liability for future salary and benefit increases.

The Administration also proposes to increase ceilings on deductible contributions substantially beyond current obligations. This is an important tool that will allow employers to pre-fund their obligations during favorable economic times in order to reduce the likelihood that their plans will become underfunded during economic downturns or times of financial stress. We support this proposal. However, by itself, it is insufficient.

3. Repeal the 25% of compensation limit for Title IV plans.

Several provisions of present law truncate an employer's ability to fund for future benefits on a continuous basis. Removing only one or two barriers is insufficient if an employer will simply run into a different impediment. As the cost of an employer's defined contribution plans has increased, more and more employers who sponsor both defined benefit and defined contribution plans have seen their funding ability curtailed by a rule that limits deductible contributions to both types of plans to 25% of compensation. The current limit is artificial, arbitrary, counter productive and unrelated to actual funding requirements.

4. Eliminate the 10% excise tax on nondeductible contributions.

An employer that makes a nondeductible contribution to a pension plan not only loses the deduction but is subject to a 10% excise tax on the amount contributed. If an employer wants to make a large contribution to its plan it should be allowed to do so without incurring a penalty. Both plan participants and the PBGC benefit from such contributions.

5. Allow pension plans to fund savings plan contributions on behalf of the pension plan's participants.

Under present law, the deck is stacked against putting available cash into the pension plan. Even the enactment of the first four proposals in this section cannot completely re-balance the circumstances. The problem is that money once contributed to the plan for all practical purposes remains stuck there even if the plan becomes substantially overfunded. An employer who takes excess money out of the pension trust faces confiscatory taxes of up to 90% on the funds removed from the plan.

A very limited exception applies (in IRC sec. 420) to money that is re-allocated to pay current retiree health benefits to plan participants. This has proved to be a valuable tool that has worked well in situations where the employer provides health benefits to retirees and been extended by Congress on two separate occasions.

The favorable impact of sec. 420 is limited because many employers do not provide health benefits to retirees. These employers are likely, however, to provide a 401(k) or other savings plan for their employees.

Thus, for several years ERIC has proposed that amendments be enacted so that, under rules similar to those in sec. 420, a employer whose pension plan assets significantly exceed its liabilities be allowed to transfer those extra monies to fund savings plan contributions on behalf of the pension plan's participants.

C. Proposals Regarding The Solvency of the Pension Benefit Guaranty Corporation

The Administration has expressed serious concerns that the funded status of the Pension Benefit Guaranty Corporation will deteriorate in the future.

In addition to the short-term funding proposals outlined above, to address this concern, the Administration also has proposed to:

- dramatically increase both the flat rate and variable rate premium-taxes paid to the PBGC and provide for automatic increases in premiums in the future;
- prohibit the payment of shut down benefits from a pension plan;
- freeze the benefit guarantee amount at the time of bankruptcy and allow the creation and perfection of liens by the PBGC for missed required contributions when a company is in bankruptcy;
- prohibit amendments that increase benefits in a plan that is less than 80% funded;
- prohibit payment of lump sums in a plan less than 60% funded, in a plan less than 80% funded if the sponsor is below investment grade, or in a plan less than 100% funded if the employer is in bankruptcy; and
- freeze the plan if the sponsor is in bankruptcy and the plan is less than 100% funded, and freeze the plan and prohibit funding of executive compensation if the plan is less than 60% funded and the sponsor is below investment grade.

ERIC proposes that Congress:

1. **Reject the Administration's proposed increases in the PBGC premium.**

2. **Treat shut-down benefits as a plan amendment for funding and guarantee purposes as of the date they are triggered. Also apply to shut-down benefit payments the restrictions under present law and proposed below that apply to payment of lump sums.**

3. **Freeze the benefit the PBGC will guarantee at the time of bankruptcy.**

4. **Prohibit amendments that increase benefits if the plan is less than 70% funded and has been less than 100% funded for more than a year.**

5. **If the plan sponsor is in bankruptcy, limit the percentage of any lump sum that can be paid to the plan's funded status.**

6. **Retain present law prohibitions on benefit amendments in bankruptcy as well as present law prohibitions on lump sum and other accelerated forms of benefit payments in the case of a plan with a liquidity shortfall.**

7. **Encourage employees to opt for annuity payout forms by (a) conforming the interest rate applicable to lump sums to the corporate rate used for funding; and (b) providing tax incentives (e.g., a 15% tax rate) for annuity payments from qualified plans.**

8. **Provide for greater flexibility in developing solutions for specific industries that will increase the likelihood that companies will be able to restructure their enterprise and avoid distress terminations of their pension plans.**

Discussion:

1. Reject the Administration's proposed increases in the PBGC premium.

ERISA (section 4002) requires that PBGC premiums be kept at the lowest possible level that will allow it to fulfill its obligations to pay benefits to participants in the plans it trustees. The Administration has failed to make the case that the PBGC needs a premium increase at this time in order to meet its obligations. As Administration officials have stated, the PBGC does not face a liquidity crisis. This is evident when one considers that in 2004 the PBGC benefit payments were substantially exceeded by premiums paid and returns on assets held by the PBGC. In that year, the PBGC paid $3.007 billion in benefits – but received $1.485 billion in premiums and earned $3.197 billion on the assets it holds. [PBGC 2004 Annual Report, pp. 2 & 15]

The relevant data concerning the need for a premium increase is not the PBGC's current deficit or surplus but its ability to pay benefits over the long term. By contrast, the premium increases proposed by the Administration are designed to retire the PBGC's entire projected deficit in less than 10 years even though the obligations involved will stretch out over 30-40 years or longer and may or may not occur. This is an unreasonable burden to place on plan sponsors and one that is in violation of the PBGC's charter as outlined in ERISA.

Moreover, the Administration proposes to index increases in the flat rate premium – which would have the result of increasing premiums on all plan sponsors regardless of whether the agency needed the money or not. It also proposes to allow the PBGC to set the variable rate premium at whatever level it chooses. This would be an inappropriate and dangerous transfer of authority from Congress to an agency. Both the solvency of the PBGC and the need to sustain a regulatory environment that encourages employers to establish and maintain defined benefit plans must be considered in setting premium levels. Only Congress has the broad view that can accomplish both goals.

2. Treat shut-down benefits as a plan amendment for funding and guarantee purposes as of the date they are triggered. Also apply to shut-down benefit payments the restrictions under present law and proposed below that apply to payment of lump sums.

The Administration's proposal would needlessly jeopardize benefits that are vital to workers, especially older workers, whose place of employment is being shut down. While it is true that under the current structure the PBGC's liability can be increased for shut down benefits for which no funding has been allowed under current law, the solution is not to abolish the benefits in all instances – including in ongoing, well-funded, and even over-funded plans that can easily afford them. The solution is to adjust the funding and guaranty rules to protect the PBGC from sudden increases in its liability.

Shut down and other contingent benefits typically cannot be funded until they are triggered by the contingent event. This makes sense because the triggering of such benefits is nearly impossible to predict on a reliable basis. On the other hand, under present law, shut-down benefits are guaranteed by the PBGC. For shut downs that occur just before an underfunded plan terminates the PBGC must assume a liability for which there has been no opportunity for funding to occur.

Most shut down benefits are paid without imposing any liability whatsoever on the PBGC. They are paid from an ongoing plan that is not terminating or from a plan that is terminating but is well- or over-funded. Thus, if shut-down benefits are treated as a plan amendment for both funding and PBGC guarantee purposes, the PBGC's exposure is contained while preserving the payment of shut down benefits in the vast majority of circumstances. Moreover, such treatment would be consistent with other types of benefits that accrue shortly before termination but were previously unknown (i.e., plan amendments).

As an additional measure of protection, the same restrictions could be placed on payment of shut down benefits as are proposed below regarding payment of lump sum benefits.

3. Freeze the benefit the PBGC will guarantee at the time of bankruptcy.

Bankruptcy proceedings can stretch out over a long period of time. We agree with the Administration that the PBGC guarantee limit should be frozen for a plan at the time of the bankruptcy filing.

4. Prohibit amendments that increase benefits if the plan is less than 70% funded and has been less than 100% funded for more than a year.

Under current law, amendments that increase benefits are prohibited if they would reduce the plan's funded status below 60% unless simultaneous action is taken to restore the plan at least to a 60% funded level. The Administration proposes to raise this bar to 80%. This is simply too high. As we noted earlier, only 3.3% of the dollar amount of all claims received by the PBGC from 1975 through 2003 came from plans that were funded at a 75% or higher level on a termination basis. Plans that are reasonably well funded simply are not a threat to the PBGC and should be allowed to operate without government interference. Moreover, we have proposed that the amortization period for plan amendments that increase benefits be reduced from 30 to 10 years, a very significant change that will ensure that funding for plan amendments is significantly accelerated.

On the other hand, a plan that is 60% funded can present a significant exposure to the PBGC. Thus we propose that the 60% level be increased to 70%.

5. If the plan sponsor is in bankruptcy, limit the percentage of any lump sum that can be paid to the plan's funded status.

The Administration has proposed to prohibit payment of lump sums under a variety of circumstances in an apparent effort to curb the depletion of assets in a plan that might be transferred to the PBGC. Unfortunately, the PBGC's proposal is far too broad, sweeps into its net too many plans that will not be transferred to the PBGC, and thus will cause serious and completely unnecessary disruption for older workers who are nearing retirement and have little chance to rearrange their plans. Moreover, the PBGC's abrupt approach is likely to trigger the very "run on the bank" it seeks to avoid as workers eligible to take a lump sum will do so prematurely rather than risk losing it later.

A less disruptive approach that still protects the PBGC would be to apply restrictions only if the plan sponsor is in bankruptcy and, in these circumstances, to limit the percentage of a lump sum that can be paid to an individual to the plan's funded status. In other words, if the employer is in bankruptcy and the plan is 80% funded, then eligible individuals could receive 80% of their benefit in the form of a lump sum.

6. Retain present law prohibitions on benefit amendments in bankruptcy as well as present law prohibitions on lump sum and other accelerated forms of benefit payments in the case of a plan with a liquidity shortfall.

Bankruptcies can take several years to work through, and key to the employer's ability to turn the business around is its ability to retain knowledgeable and skilled employees. The Administration proposes to freeze the company's pension plan at the start of a bankruptcy, even if the plan is 99% funded. This hammer-blow approach will, in fact, harm rather than protect the PBGC by making it far more likely the company will not be able to retain the key employees it needs to effect a recovery.

Under present law, if the employer maintaining a plan is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan – including by an increase in benefits or any change in the accrual of benefits or in the rate at which benefits vest under the plan. Plans that have assets equal to less than three years of benefit payments may not make lump sum payments or other payments that deplete assets on an accelerated basis. These provisions of law should be retained.

7. Encourage employees to opt for annuity payout forms by (a) conforming the interest rate applicable to lump sums to the corporate rate used for funding; and (b) providing tax incentives (e.g., a 15% tax rate) for annuity payments from qualified plans.

Incentives, rather than penalties are usually a more effective way to achieve desired policy results. Instead of arbitrary and disruptive limits on payments of lump sum benefits – which are merely likely to result in employees taking their lump sums at an earlier date – much more could be accomplished by erasing the current imbalance between lump sum and annuity valuations caused by required use of disparate interest rates. In that way, the choice between a lump sum and an annuity payout would be economically neutral, as it should be. If it is desirable to take a further step and encourage individuals to elect annuity payment forms, this could be done by providing a tax incentive (for example, a 15% tax rate) for annuity payments from qualified plans.

8. Provide for greater flexibility in developing solutions for specific industries that will increase the likelihood that companies will be able to restructure their enterprise and avoid distress terminations of their pension plans.

From time to time there will be specific industries that, as a result of factors such as significant adverse economic conditions or industry specific problems, require funding solutions that differ from otherwise generally applicable funding rules. Recognizing that the PBGC is best served when companies in troubled industries can restructure and survive, the government should have the flexibility to work out rational programs that reduce pressure on a company in a troubled industry while also ensuring that the funded status of the company's plans does not worsen.

D. PROPOSALS REGARDING DISCLOSURE

The Administration is concerned that "accurate information about a plan's funding status is needed earlier."

To address this concern, the Administration proposes to:

- require all plans to disclose both their ongoing and termination liabilities on their Forms 5500;
- require earlier scheduling of the Form 5500 Schedule B;
- revise Summary Annual Reports to show a plan's funded status relative to its funding target for each of the last three years and to include in the SAR information on the company's financial health and on PBGC guarantees (the participant notice under section 4011 would be eliminated);
- accelerate the distribution date for SARs to 15 days after the filing of the Form 5500.

ERIC proposes:

1. **Provide participants annually with a statement of the plan's funded status based on timely information currently available – such as**

information on plans compiled for SFAS 87 disclosure.

2. **Replace the SAR with the report described above.**

Discussion:

More meaningful and more timely disclosure to participants is needed. Investors receive better and more timely information than do plan participants. At the same time, imposing additional disclosure costs on plans and confusing participants with disparate measures of a plan's status is not helpful as it results in less money available for benefits and does not enlighten the participants.

It is particularly excessive to require plans to go to the extra expense of calculating and publishing termination liability numbers. As noted earlier, in its entire 30-year history, the PBGC has trusteed only 3,277 plans (by 2003). Over that same period, approximately 194,000 defined benefit plans either have concluded their business through standard (i.e., fully funded) terminations or are still in existence. This means that for every plan trusteed by the PBGC, approximately 60 other plans have not been trusteed.

In addition, the SAR is not a meaningful report and, in our experience, is not read by participants. It should be abolished.

Conclusion

As the PBGC has stated, the agency faces potential long term issues but does not face a liquidity crisis. It has on hand sufficient assets to pay trusteed benefits for many years into the future. Moreover, when it trustees a plan, its asset base grows. Potential issues regarding the PBGC are long term issues that may or may not become reality.

In that regard, we note that of the $23 billion deficit published by the agency at the end of 2004, $17 billion (or nearly three-quarters) was due to claims that had not yet been received by the agency – called "probable" claims. Probable claims are those the agency expects to receive in the near future, although not necessarily in 2005.

The PBGC is locking in its recent investment losses by transferring its investments to bonds and fixed income, and the Administration is proposing that the entire projected PBGC deficit be paid off by plan sponsors over the next ten years or less. This is wrong, and it is self-defeating. The PBGC's investment policy should be reviewed, and its premium proposals rejected.

This self-defeating approach to PBGC security is compounded by the Administration's proposals to impose volatile and overly expensive funding requirements on all plans and to impose an expansive definition of liability as well as harsh benefit and guarantee restrictions on the plans of any company that drops below investment grade. At a minimum, the Administration's proposals are a strong incentive for employers not to sponsor defined benefit plans in the future, further weakening, not strengthening, the PBGC's future prospects.

More importantly, the Administration's proposal will weaken the retirement security of future retirees just as the baby boom is reaching critical ages. If the proposals are enacted, millions of workers will enter retirement with less money.

Steps such as those recommended above by ERIC can – and should – be taken to improve the functioning and security of defined benefit plans while also protecting the PBGC against unreasonable plan losses.

SUMMARY OF CONSENSUS LEGISLATIVE PROPOSALS AFFECTING HYBRID PENSION PLANS

INTRODUCTION

I. **Congress should promote the creation and continuation of voluntary employer-sponsored retirement plans.**

II. **Congress should foster the development and continuation of defined benefit retirement plans by giving employers the flexibility they need to maintain defined benefit plans that meet employer and employee needs. Virtually all private sector defined benefit plans**

- A. provide that employees earn benefits automatically without being required to make contributions,
- B. protect employees against investment risk,
- C. provide benefits that are guaranteed by the PBGC, and
- D. provide that the normal form of benefit distribution is an annuity.

III. **Hybrid defined benefit plans, such as cash balance and pension equity plans, meet the needs of many employers and employees in the 21st Century, including many older employees.**

- A. They are the only type of plan that is stimulating greater interest among employers in retaining and expanding defined benefit plans.
- B. They allocate benefits more evenly among long-service and short-service employees than do many traditional plans.
- C. They are particularly attractive to women and other workers whose careers are interrupted to raise a family or for other reasons.
- D. They are work-neutral: they do not penalize an employee for terminating employment <u>before</u> reaching retirement age
  - i. This helps not only employees who choose to change employers but also employees who are involuntarily laid off.
  - ii. Benefits continue to grow even after an employee terminates.
- E. They are work neutral: they do not penalize an employee for working <u>beyond</u> normal retirement age.
  - i. The value of the benefit for an older employee increases at the same rate both before and after normal retirement age.
  - ii. By contrast, under a traditional defined benefit plan, especially a plan that offers subsidized early retirement benefits, the economic value of an employee's benefit can actually decline when an employee works past the plan's early or normal retirement age.
- F. They provide benefits that employees understand and appreciate.
- G. They provide that the normal form of benefit distribution is an annuity.
- H. Most provide portable benefits that may be rolled over, on a tax-deferred basis, to an IRA or to another employer's plan for continued retirement savings.

IV. **In adopting hybrid plans, employers have reasonably relied on Government guidance, which has indicated on a number of occasions that hybrid plans are lawful, including:**

- A. The preamble to the final § 401(a)(4) regulations;
- B. The regulatory safe harbor for cash balance plans [see Treas. Reg. § 1.401(a)(4)-8(c)(3)];
- C. Notice 96-8; and
- D. IRS determination letters.

GENERAL PRINCIPLES

I. Any legislation must not impair employers' ability to change or terminate their plans in the future.

A. Employers are not required to adopt benefit plans; they offer plans voluntarily as part of a package of compensation and benefits.

B. If employers lose their ability to change or terminate their plans, many employers will, when faced with changing business or economic circumstances, be locked into existing plans that put them at a competitive disadvantage and that do not meet employees' needs -- jeopardizing the employer's viability, the future employment of its employees, and the employer's ability to provide benefits to retirees in the future.

C. If employers become concerned that they will not be able to change or terminate their plans in the future, they will terminate their existing plans and will not adopt new plans.

D. There is no basis for enacting legislation to assure that "employee expectations" regarding the future of a pension plan are realized. Because pension plans are frequently modified, both to include enhancements and to limit or reduce the benefits to be earned in the future, there is a wide range of "employee expectations;" no single hypothetical "employee expectation" could serve as the basis for any such legislation.

II. Employees are adequately protected by current law, which prevents an employer from amending a pension plan to reduce accrued benefits or reducing vested rights.

A. Current law not only prohibits an employer from amending a plan to reduce the pension benefits that employees have already earned, but also requires the plan, after it has been amended, to continue to give employees credit for their service for purposes of qualifying for any early retirement subsidy that applies to the pension benefits that the employees had earned at the time of the plan amendment.

i. For example, if an employer amends a pension plan to provide that pension benefits earned in the future will not include an early retirement subsidy, employees are still entitled, after the amendment, to continue to earn service credit for purposes of qualifying for any early retirement subsidy that applies to the pension benefits they have already earned.

III. Legislation must protect the past actions taken by employers as long as –

A. The plan's benefit formula(s) was (were) not age discriminatory on their face, and

B. The plan complied with the anti-cutback rule.

IV. Legislation clarifying that hybrid plans are not inherently age discriminatory must be effective both retroactively and prospectively.

Specific Proposals

I. **Compliance with Age Discrimination Law.** Confirm, both retroactively and prospectively, that plans that recognize the time value of money, such as cash balance plans, pension equity plans, contributory defined benefit plans, indexed career pay plans, and variable annuity plans, are not age discriminatory.
   A. Enact legislation that states that a plan may not decrease or stop the accrual of benefits based on the attainment of a particular age. This would not prohibit a cessation or reduction of a participant's accrual rate for reasons other than age (e.g., because of a benefit limit, a ceiling on credited service, or a plan amendment that reduces the plan's accrual rate).
      i. Focus is on text of the plan; and
      ii. Mathematical testing is not required.

II. **Standards Applicable to Conversions.** With respect to the age discrimination standards that apply to conversions of traditional plans to hybrid plans, a conversion would comply with the age discrimination standards if each of the following requirements was satisfied:
   A. Neither the old benefit formula nor the new benefit formula discriminated, on its face, on the basis of age (i.e., neither formula provided that a participant stopped earning benefits, or started earning benefits at a lower rate, once the participant attained a particular age); and
   B. The conversion did not violate the anti-cutback rule as in effect on the date of the conversion.

III. **Elimination of Whipsaw.** Legislation should eliminate whipsaw both prospectively and retroactively (excluding cases that have been finally resolved).

IV. **Amendments to Anti-backloading Rules.** Legislation should amend the anti-backloading rules, both prospectively and retroactively, to provide that if a plan provides participants with the benefit produced by two or more alternative formulas, the plan will comply with the anti-backloading rules if each of the formulas, tested separately, complies with those rules.
   A. This allows an employer that converts its traditional defined benefit plan to a hybrid formula to offer generous transition benefits to affected plan participants.

V. **Offset for Benefits Provided by Another Plan.** The legislation should also clarify, both prospectively and retroactively, that if a plan provides for an offset for benefits provided by another plan, the plan will comply with the anti-backloading rules if the gross benefit formula (i.e., before application of the offset) complies with the anti-backloading rules.
   A. In the case of a floor-offset arrangement involving a defined benefit plan and a defined contribution plan, where the benefits under the defined benefit plan are offset by the actuarial equivalent of the benefits under the defined contribution plan, the defined benefit plan complies with the anti-backloading rules if its gross benefit formula (i.e., before application of the offset) complies with the anti-backloading rules.

VI. **Nondiscrimination Rules.** The legislative history should direct the Treasury not to revisit the nondiscrimination testing issue raised by the proposed § 401(a)(4) regulations that the Treasury has withdrawn.
   A. Because hybrid plans are defined benefit plans, it should always be permissible to test them as defined benefit plans under § 401(a)(4) as well as to cross-test them as defined contribution plans.

VII. **Determination Letters.** The legislative history should direct the Treasury to begin issuing, by a date certain, determination letters to plans that have been converted from traditional designs to hybrid designs.

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