



GOVERNMENT QUESTIONS ON HYBRID PLANS

1. **QUESTION.** *Does the government have the authority under the statute to permit interest crediting rate reductions that are more than “necessary” to comply with the law?* We have asked for flexible anti-cutback relief that permits plans with above market rates to reduce those rates to one of several different safe harbor rates. One question that was raised in discussions is whether the IRS and Treasury have statutory authority to follow our proposal if it is considered to provide more relief than is “necessary.”

ANSWER. Each of our suggested safe harbors fits within the “to the extent necessary” standard. Just as there is no one single “market rate of return”, there is no reason to think that one permitted market rate is inherently higher than another, and thus should be the sole way to comply with the “to the extent necessary” standard. For example, if the maximum fixed rate permitted is 6% and a plan currently provides 6.5%, it clearly should be permitted to reduce the 6.5% to 6%, but it is not at all clear that lowering the 6.5% to 6% is the only way to reduce the rate “to the extent necessary”. It could very easily be argued, for example, that “reducing” to the third segment rate is a smaller long-term reduction. Or the opposite could be argued. In this circumstance, it seems arbitrary and counterproductive to designate only one of those as meeting the “to the extent necessary” standard.

There is a further question as to whether the IRS and Treasury are bound to follow the “to the extent necessary standard” since the standard is a regulatory standard, not a statutory standard. We believe that the IRS and Treasury have the power to modify that standard. For example, please see the instances in existing Regulation § 1.411(d)-4 Q&A-2(b) where discretion is exercised to permit small reductions or eliminations of otherwise protected benefits in certain very discrete situations for reasons of administrative convenience rather than compliance with the law. This supports the position that minor reductions in otherwise protected benefits can be permitted where the reduction helps facilitate the workability of plans. Thus, permitting a reduction in interest crediting rates that is only slightly more than necessary but greatly facilitates plan workability for sponsors and participants would be entirely consistent with past exercises of Treasury and IRS authority. Our suggested safe harbors would also be consistent with the Congressional intent behind section 1107 of the Pension Protection Act. The transition standard should be flexible enough to facilitate a reasonable transition to a standard that has not been established.

2. **QUESTION.** *If the government concludes that our proposal would provide more anti-cutback relief than the government has authority to provide, would we feel comfortable with a less flexible approach so that there is a single safe harbor rate for every above market interest crediting rate?* For example, a bond-based rate that is above market might only be reduced to the third segment rate under the safe harbor.

ANSWER. In our view, providing only a single safe harbor that applies in all cases is not the best approach. As illustrated above, it is not at all clear what the one safe harbor rate should be in any case, from a participant's perspective. As another example, one permissible rate may be higher in the short term than a second permissible rate, but lower in the long term. Since plans have different participants some of whom will remain in the plan for shorter periods and others for longer periods, a reduction "to the extent necessary" for one group could be more than necessary for the other group. And what single rate would be appropriate for plans that currently offer participant direction among investment options? Moreover, establishing a single safe harbor for each above-market rate could require a great deal of complexity in creating precise rules that govern every conceivable situation.

3. **QUESTION.** *How much interest is there in using updated margins associated with the rates listed in IRS Notice 96-8?* The margins listed in IRS Notice 96-8 and used in the hybrid plan regulations were based on making the rates equivalent to the 30-year Treasury rate. But in the context of the proposed regulations, the successor to the 30-year Treasury rate is the third segment rate, which is significantly higher than the 30-year Treasury rate. Thus, the margins listed in the hybrid regulations produce rates of return that are systematically too low and conceptually should be updated. But updating the margins would require substantial government resources. Is there sufficient interest in using the updated margins to justify the substantial expenditure of government resources needed to do the updating?

ANSWER. We believe that we can help facilitate the updating process and make it less burdensome for the government.

We are not currently aware of any significant interest in updated margins, but unfortunately, until the rules are finalized and employers know what their choices are, we can only speculate as to whether such interest will arise.

In one large database (consisting of 450 plans), six plans have interest crediting rates that are based on Treasury rates but with a margin that exceeds the margin permitted by IRS Notice 96-8. These six would certainly have an interest in updated margins.

The harder group to predict is the group that uses the maximum margin permitted by Notice 96-8. That group includes almost half of the plans in the

database. We expect that many plan sponsors would welcome the flexibility to provide more generous benefits by increasing the margins, but that is only speculation at this point.

We also want to reiterate one point raised at the meeting. The transition issues related to the “to the extent necessary” standard and the ongoing section 411(d)(6) issues will be far simpler if all the permitted “market rates” are viewed as equivalent in a market sense. Such equivalence would eliminate many concerns about plans changing among the permitted rates. However, we will not achieve that broad equivalence unless the Notice 96-8 margins are updated.

Please note that we are not saying that the third segment rate should be viewed as the universal measure of a market rate of return. It is not. Rather, we are saying that the third segment rate is the successor to the 30-year Treasury rate in the Notice 96-8 regime and that achieving equivalence—and the resulting uniformity and simplicity—requires updating the Notice 96-8 margins to match the third segment rate rather than the 30-year Treasury rate.

4. **QUESTION.** *Would we be comfortable with guidance which stated that stabilized segment rates would be treated as above market?* This question relates to plans currently using one of the segment rates as their interest crediting rate and the need for guidance on whether a stabilized or non-stabilized rate would apply for periods starting with the 2012 plan year (in the absence of a plan amendment if permitted). If the stabilized rates apply for the 2012 year, plans using a segment rate could have a material retroactive liability. Treating the stabilized rates as above market would be one way to prevent that result, albeit at the cost of long-term flexibility in setting rates of return.

ANSWER. Approximately 5% of the plans in the plan database noted above refer in some manner to the segment rates in setting their interest crediting rates. We do not know how they are dealing with the plan interpretive issue triggered by MAP-21. The guidance on this point in IRS Notice 2012-61 was helpful and may be enough for us to prefer that the stabilized rates not be treated as above market, so as to preserve future flexibility. However, companies are still reviewing this issue.

Please note that treating both stabilized and unstabilized rates as market rates would, as noted, provide flexibility to plan sponsors, and could prove useful in smoothing the transition to the final regulations. Specifically, Treasury and IRS should consider permitting (but not requiring) any plan with an above-market interest crediting rate to retain that rate but to cap it after the effective date of the final regulations at the greater of the stabilized and unstabilized third segment rates. This approach would minimize any cutbacks required in participants’ accrued benefits in implementing the final regulations.

5. **QUESTION. Is there evidence that a reasonable interpretation standard makes a difference in litigation?** Generally, the new hybrid plan statutory requirements enacted as part of the Pension Protection Act of 2006 have been effective for a few years but the regulations take effect much later. The question relates to whether a reasonable interpretation standard is needed for the interim period. If courts generally ignore a regulatory reasonable interpretation standard, it may not be necessary to include the standard in the regulations.

ANSWER. If the regulations (1) state that a reasonable interpretation of the statute (not limited to interpretations adopted in other agency guidance, such as the proposed or final regulations) constitutes compliance with the law, and (2) explicitly recognize that more than one such reasonable interpretation can exist, it can make a difference in litigation. See, for example:

The court believes that the chosen method of KCSI in delivering the [COBRA] notices was reasonably calculated to reach those to whom they were directed. The court further notes that the same conference committee stated that, “pending the promulgation of regulations, employers are required to operate in good faith compliance with a reasonable interpretation” of COBRA’s requirements. H.R.Rep. No. 453, 99th Cong., 1st Sess. 563. KCSI’s chosen method of delivery was at the very least a good faith attempt to comply with a reasonable interpretation of COBRA’s requirements, and KCSI was not in violation of ERISA for delivering the notices in that manner.

Plaintiffs further contend that the contents of those notices were inadequate to comply with COBRA’s requirements. The court has reviewed the language of COBRA, along with the language set out in the notice sent out by KCSI on July 1, 1986, and has concluded that KCSI’s notice was substantially in compliance with COBRA. The court’s conclusion on this matter is guided in large part, again, by the conference committee’s requirement that employers operate in good faith compliance with a reasonable interpretation of COBRA’s requirements.

Dehner v. Kansas City Southern Industries, Inc., 713 F. Supp 1397, 1400-1401 (D. Kan 1989).

Following what seems to us to be manifest Congressional intent, we find that the notice was properly sent because sending it to the last known address constituted “good faith compliance with a reasonable interpretation of” COBRA.

Crawford v. Pennsylvania Employees Benefit Trust Fund, 1994 WL 249808.

In contrast, the failure to include a good-faith compliance standard could result in its denial by a court. *Cf., e.g., Towner v. CIGNA Life Ins. Co. of N.Y.*, 419 F. Supp. 2d 172, 179 (D. Conn. 2006) (refusing to adopt a good faith compliance standard in a non-transition context, observing that “in enacting the new regulations, the Department of Labor expressly rejected making ‘good faith compliance . . . the measure for requiring administrative exhaustion’”).

In addition, we believe that an explicit reasonable interpretation standard will serve to discourage and reduce unfounded litigation, which may explain why this issue arises only occasionally in litigation. Moreover, establishing a reasonable interpretation standard is the fair and appropriate thing to do, since from a practical perspective, employers generally cannot reduce existing interest crediting rates until there is final guidance, particularly guidance on anti-cutback relief.

6. **QUESTION.** *How many plans currently permit participant choice of interest crediting rates among a menu of options and how much interest is there in this option?* Working through the rules necessary to facilitate participant choice would require significant government resources. Accordingly, during the discussions, the following questions came up: **(1) how much of a difference would permitting participant choice make in stimulating the defined benefit system, and (2) do participant choice arrangements raise fiduciary issues regarding the prudence of any available crediting rate?**

ANSWER. A large number of participants currently are permitted to elect to allocate their cash balance accounts among a menu of investment alternatives (albeit in a relatively small number of large plans). The design is popular with participants in these plans, who are likely to be upset if the option to direct their accounts is taken away from them by the final regulations.

In any event, it is appropriate for the final regulations to confirm the validity of participant choice. Congress was aware of plans offering participant choice when it enacted the market rate of return standard and, in fact, took such plans into account in adopting that standard. Furthermore, it is our understanding that the “preservation of capital” rule in Code § 411(b)(5)(B)(i)(II) and the “protection against loss” rule in Code § 411(b)(5)(E)(ii) were derived primarily from an existing cash balance plan that included such protection for accounts subject to participant direction among a full menu of hypothetical investment alternatives. To prohibit such plans would thus be inconsistent with Congressional intent.

We believe it is critical to the future of defined benefit plans to permit plan designs that share investment risk between the plan sponsor and plan

participants. Furthermore, if participants are to bear investment risk, plan sponsors should have the ability to vary the degree of risk participants bear so that it is appropriate to their circumstances. For example, plan sponsors may not wish individuals nearing and in retirement to bear the same degree of investment risk as participants further from retirement. Participant direction is one long-accepted method of matching investment risk to individual participant risk tolerances. There are other accepted methods as well. The final regulations should permit any reasonable method of achieving this objective. Without it, the market rate of return standard may ultimately be less workable as a retirement plan design.

We believe there could be substantial employer interest in defined benefit plan designs that permit the sharing of investment risk with participants. Such designs substantially reduce funding and financial accounting volatility for plan sponsors, yet provide enhanced retirement security to participants relative to defined contribution plans (through, for example, principal protection, mandatory availability of guaranteed lifetime income, and restrictions on distributions prior to termination of employment). Logical candidates for these plan designs would be employers that intend to move from a conventional defined benefit design to a defined contribution design. Plan designs that permit the sharing of investment risk with participants would be an attractive alternative to such a move. We also believe that such plan designs offer an efficient way for employers to provide retirement benefits to their employees. In the long run, these efficiencies will tend to attract more employers to these plan designs.

If Treasury and IRS are not comfortable permitting existing levels of participant direction in the final regulations, participant direction at those levels should still be permitted during the interim period between the statutory and regulatory effective dates, because it is too late to retroactively eliminate the choices that participants have already made. Furthermore, we would suggest that, in addition to any other transition methods available, the final regulations

(a) permit self-direction of pre-existing account balances after the regulatory effective date, and/or

(b) provide anti-cutback relief that would permit plan sponsors, if they so choose, to move from current levels of participant direction after the regulatory effective date to another method of matching investment risk to individual participant circumstances, for example, by using either of the qualified default investment alternatives permitted under 29 C.F.R. § 2550.404c-5(e)(4)(i) & (iii), as further discussed in Q&A-8 below.

We do not believe that participant choice raises fiduciary issues regarding the prudence of any available crediting rate. For example, it is undisputed that if a plan were to credit a fixed rate that is clearly below market, the crediting rate

would be treated as a settlor decision that is not subject to ERISA's fiduciary standards. The analysis of any other crediting rates, with or without choice, is the same. The only legal requirement is the obligation to preserve principal. Moreover, we believe that, if participant choice is permitted, employers will in many cases mirror the same options (or a subset of the options) that are available in the employer's 401(k) plan; as a result, the selection of the menu of investment options will reflect the decisions made by fiduciaries in accordance with their Title I obligations under the employer's 401(k) plan.

7. **QUESTION. *Is there any available information on trends with respect to the percentage of participants receiving annuities as opposed to lump sums?***

ANSWER. There was an informal but detailed survey of a dozen large cash balance plans in a variety of geographic areas and industries. Overall, there has been a generally consistent drop in immediate lump sum distributions at termination of employment over the last few years, generally from 80% to something closer to 50%. The reason given for the change is typically the uncertainty in the economy and the interest credits that can be earned in the plan. A few plans have seen consistent lump sum election rates over the period. Annuitization was not significant anywhere within the survey. The trend appears to be toward deferral of the lump sum, not toward increased interest in an annuity. Preliminary data on several bulk lump sum projects suggest immediate election rates of about 60%, again suggesting that participants are not universally choosing to take an immediate lump sum.

While the survey did not identify any measureable increase in annuity elections, the decrease in immediate lump sum elections suggests that there may be an opportunity to increase annuitization and other lifetime income options through policy efforts. This opportunity is really the critical point. The prevalence of lump sum elections is not a hybrid plan issue; it is an issue common to all retirement plans. In fact, the opportunity to promote lifetime income options—through education and more attractive distribution options (such as partial and longevity annuities)—is greater in hybrid plans than in defined contribution plans where, for example, the infrastructure to administer the spousal consent rules may or may not exist. In fact, there are some large hybrid plans that do not offer lump sums and others that do not offer a lump sum payment of a participant's entire benefit.

8. **QUESTION. *If participant choice is not permitted, would it be age discriminatory for a plan to require all participants to be "placed" in an age appropriate target date fund for interest crediting purposes?*** The concern would be that younger participants would be invested in more aggressive portfolios with a higher expected rate of return and higher risk. If the test for age discriminatory turns solely on the higher expected rate of return

(or actual return in many years), some may be concerned that that could be considered age discrimination.

ANSWER. We believe that the contemplated plan design is not age discriminatory. No younger participant is receiving a more favorable crediting rate; all participants are receiving an age-appropriate crediting rate, taking into account participants' time horizon and general risk profile.

Target date funds vary their asset allocations based on expected time horizons in order to minimize volatility as the individual participant nears and enters retirement. A dollar invested in one fund is not worth more or less than a dollar invested in another fund. Instead, funds with shorter time horizons generally expect less volatility in their returns — a key component of modern portfolio theory. Placing an individual in a particular fund based on the individual's approximate retirement horizon therefore does not mean that the individual is placed in a less valuable investment than a younger person. In brief, modern portfolio theory is not age discrimination.

Furthermore, it is clear that a qualified default investment alternative (QDIA) in a defined contribution plan may be a target date fund to which participants are assigned by default based fully or in part on their respective ages. See 29 C.F.R. § 2550.404c-5(e)(4)(i) (A QDIA includes “[a]n investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy.”)

Participants in defined contribution plans may opt out of the qualified default investment alternative to which they are initially assigned. If hybrid plans are permitted to assign participants to an appropriate default target date fund, the final regulations could permit employers to adopt plan designs under which participants may opt out of the default fund into another target date fund. Alternatively, in lieu of this limited participant election, the final regulations could permit employers to adopt plan designs under which participants provide additional financial and other non-age information about their circumstances that could then be used to make their assignment to an appropriate target date fund with greater precision.

In any event, employers will need certainty in the law, and the final regulations should make clear that the design opportunities provided by the Pension Protection Act, as interpreted by the regulation, do not violate the age discrimination rules.

We note in passing that managed account QDIAs described in 29 C.F.R. § 2550.404c-5(e)(4)(iii) do not raise the same issues as target date QDIAs, since managed account QDIAs may permit participants to provide additional financial and other non-age information about their circumstances that then is applied to more precisely adjust the mix of investments in their individual accounts.

9. **QUESTION.** *How could target date funds and managed accounts be defined if a special rule is provided regarding such arrangements?*

ANSWER. Please see the DOL's definition of qualified designated investment alternatives ("QDIAs") quoted below:

(i) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph..., asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "life-cycle" or "targeted-retirement-date" fund or account.

(ii) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this paragraph..., asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "balanced" fund.

(iii) An investment management service with respect to which a fiduciary, [within the meaning of paragraph (e)(3)(i) of this section], applying generally accepted investment theories,

allocates assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, [offered through investment alternatives available under the plan,]¹ based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocation and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph, asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a service may be a "managed account."

29 C.F.R. § 2550.404c-5(e)(4)(i)-(iii).

10. **QUESTION.** *Are there any defined contribution plans where participants who elect a target date fund are being required to invest in an age-appropriate fund?*

ANSWER. We need to pursue this further.

11. **QUESTION.** *In connection with the backloading rules, do you have any examples where the factor that is held constant for backloading purposes is based on a long-term average, rather than the preceding year?* The proposed regulation allows a plan to assume a zero rate of return for projection purposes if the prior plan year crediting rate was below zero. This does not solve the backloading problem for investment-based crediting rates that can be negative.

ANSWER. We would like to make two points here.

First, as discussed at our meeting, each of the anti-backloading rules holds plan compensation constant, yet plan compensation in career and final average pay plans is based on a longer-term average, not the current plan year's compensation. Otherwise, career and final average pay plans could not satisfy the anti-backloading tests by design because the current year's compensation could be significantly higher than the average compensation and, if projected forward, would result in substantially higher accruals later in an employee's career.

¹ This phrase from the regulations would be deleted in the hybrid plan context, since it does not fit within the defined benefit plan context except in cases where the hybrid plan offers participant direction among a menu of investment options.

For example, if the highest five years of earnings for a participant in a five-year averaging plan are \$20,000, \$30,000, \$40,000, \$50,000, and \$60,000, the average of her last five years of earnings is \$40,000. But if one assumes that the employee's earnings remain constant at the current year's rate of \$60,000, when her earnings are projected forward more than five years, her average annual compensation will increase from \$40,000 to \$60,000. As a result, later accruals (based on a flat percentage of final average pay per year of service) would be more than 133-1/3% of earlier accruals as well as more than a ratable share of the projected fractional rule benefit. Yet the regulations make clear that a final average pay plan satisfies the 133-1/3% test, regardless of an employee's compensation history. See, e.g., Treas. Reg. § 1.411(b)-1(b)(2)(iii), Ex. (1). And they also provide an explicit example under the fractional rule in which the normal retirement benefit is determined by projecting 10-year average compensation of \$23,600, even though the current year's compensation is \$32,000. See Treas. Reg. § 1.411(b)-1(b)(3)(iii), Ex. (2).

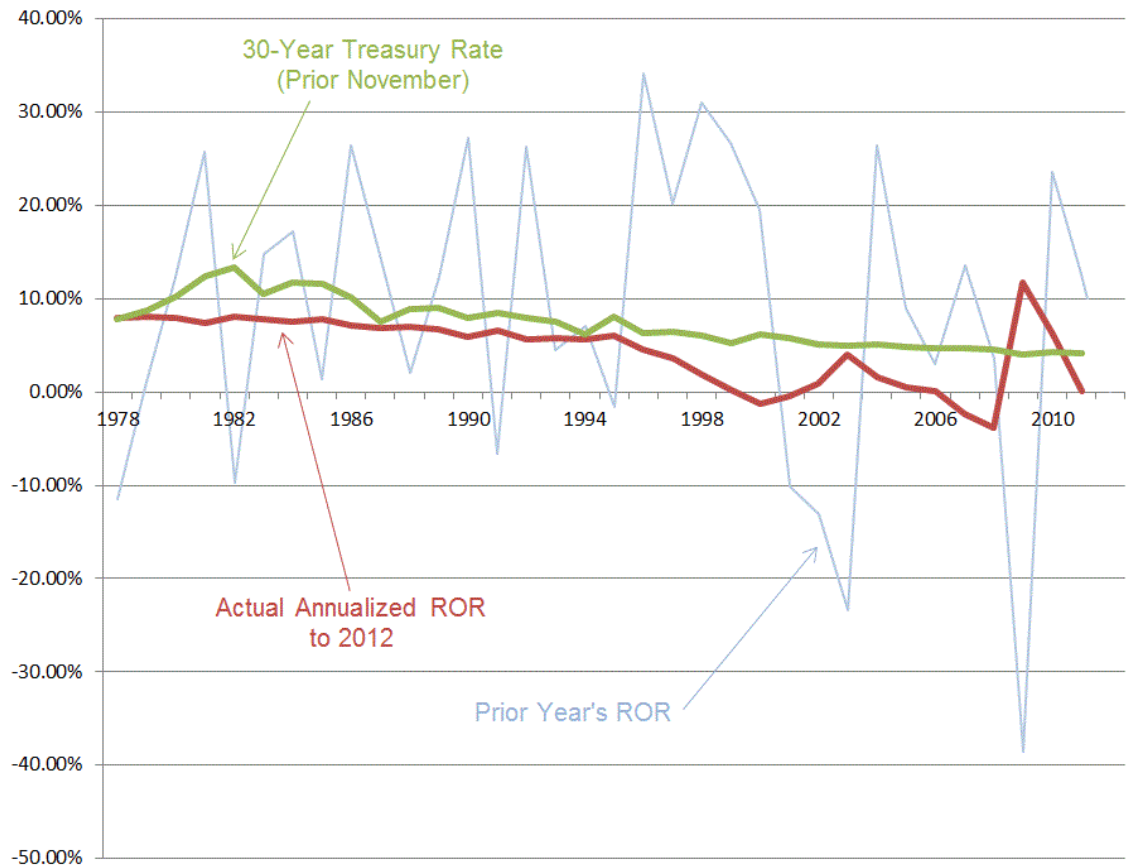
Second, the premise that the anti-backloading rules require projection at the prior year's investment return is incorrect. Code section 411(b)(1)(A)(ii) and (B)(iv) states that "all . . . relevant factors used to compute benefits shall be treated as remaining constant as of the current year for all years after such current year." Regulation § 1.401(b)-1(b)(1)(ii)(A) and (2)(ii)(D) repeats this standard, interpreting the phrase "as of the current year" to mean "as of the beginning of the current plan year."

The key term in the statute and regulations is "relevant factors" for calculating the accrued benefit. Under Notice 96-8, the "relevant factors" for calculating the accrued benefit in a cash balance plan are the participant's current account balance and a projection rate for future interest credits:

- Notice 96-8 states that the accrued benefit must be calculated based on the current account balance (which consists of prior pay credits and actual interest credits to the date of determination), plus a projection rate determined under a method set forth in the plan that reasonably reflects the value of future interest credits (projected to be credited to the account after the date of determination and through normal retirement age).
- This rule is echoed in the case law applying Notice 96-8. See, e.g., *Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755, 761 (7th Cir. 2003) (projection must "include a fair estimate of [future interest] credits").

Neither the statute, the regulations, nor any other guidance states that using the prior year's interest crediting rate is necessarily an appropriate method for determining a projection rate that reasonably reflects the value of future interest credits. To the contrary, for a plan that credits an investment rate of return, the prior year's rate of return would be an entirely *inappropriate* projection rate

under the standard set forth in Notice 96-8. This is because the prior year's rate of return does not reasonably reflect the value of future interest credits. For example, suppose the rate of return in year 1 is 20%. It is axiomatic that it is not reasonable to assume that the same 20% return will recur in every future year. The following chart illustrates this point:



This chart shows the relationship between the prior year's rate of return and the actual future rate of return for the S&P 500 for every year from 1978 through 2011. For comparison, it also includes the prior year's 30-year Treasury rate for each of those same years.

- The jagged blue line labeled "Prior Year's ROR" shows the prior year's return of the S&P 500 for each year since 1978. For example, the prior year's return for 1981 (*i.e.*, the return over 1980) was positive 25.8%; the prior year's return for 1993 was positive 4.5%; and the prior year's return for 2001 was negative 10.1%.
- The reddish brown line labeled "Actual Annualized ROR to 2012" shows the actual annualized rate of return from each year through the end of 2011. For example, from January 1982 through December 2011, the S&P 500 index grew from 122.55 to 1,258.86, which translates to an annualized return of 8.1% per year over that 30-year

period. Similarly, for the 15-year period from 1997 through 2011, the annualized return was 3.6% per year (from 740.74 to 1,258.86).

- The relatively smooth green line labeled “30-Year Treasury Rate (Prior November)” shows the 30-year Treasury rate for the November before the start of each year. For example, the 30-year Treasury rate for 1982 was 12.4% (the rate for November 1981); the rate for 1997 was 6.5%; and the rate for 2004 was 5.1%.

The chart shows that the prior year’s rate of return has no relation to the actual return in future years. Thus, if a plan credited a market rate of return equal to the rate of return on an S&P 500 mutual fund, projecting future interest credits at the prior year’s rate of return on the S&P 500 would not reasonably reflect the value of the plan’s future interest credits. Just the opposite. Projecting at the prior year’s rate of return would produce wild swings in the projected accrued benefit—**meaning that the projected accrued benefit calculated in any year would have no relationship to the benefit that a participant has actually earned.** In fact, the 30-year Treasury rate has been a much closer predictor of the actual future rate of return. In short, the chart illustrates that the prior year’s rate of return does not satisfy the requirement of Notice 96-8 to project at a rate that reasonably reflects the value of future interest credits. The prior year’s rate of return therefore is not a “relevant factor” that should be held constant in calculating a participant’s accrued benefit.

The final regulations should recognize this fact. Instead of a rifle-shot workaround to address years in which the rate of return is negative, the final regulations should require a projection rate that is consistent with the requirements of Notice 96-8:

- The projection rate must be stated in the plan;
- The projection rate must reasonably reflect the value of future interest credits; and
- The projection rate must preclude employer discretion.

In accordance with Code section 411(b)(1)(A)(ii) and (B)(iv), and the underlying regulations, the final regulations should state that the projection rate in effect for the current year must be treated as remaining constant for all future years.

Our analysis with respect to investment rates of return is not intended to suggest that the prior year’s interest crediting rate is never an appropriate projection rate. To the contrary, the prior year’s crediting rate is a perfectly appropriate projection rate when the interest crediting rate is fixed and in many cases would be appropriate when it is tied to a bond yield. This distinction is based on the fundamental difference between a bond yield and an investment return:

- If external factors (e.g., interest rate and risk) are held constant, a bond's rate of return will equal its yield. For example, if a 10-year corporate bond has a yield of 5%, the bond will return 5% per year for the next 10 years. Similarly, if external factors are held constant, the current yield on a bond index (like the Treasury yield) will continue into the future. Accordingly, it is appropriate to project the current yield into the future in most cases. See, e.g., *Berger*, 338 F.3d at 762 (stating that a current bond yield might be “an unbiased estimator of future such rates”). (As pointed out in our prior submissions, there are years in which the current bond yield is not a particularly good predictor of future interest credits.)²
- In contrast, an investment does not have an intrinsic rate of return: changes in the value of an investment are tied solely to external factors. For example, the value of a group or index of stocks is affected by confidence in the overall economy; the value of an individual stock is affected by expectations of the issuer's ability to transact business at a profit; the value of actually owning a bond (as opposed to merely being credited with its yield) depends on interest rates relative to the bond's yield; and so on. If all external factors are held constant, the intrinsic value of the investment will not change.³ Indeed, the Eleventh Circuit noted in *Lyons v. Ga.-Pacific* that an investment return is “materially different” than a bond yield. *Lyons v. Ga.-Pacific Corp. Salaried Employees Ret. Plan*, 221 F.3d 1235, 1248-49 (211th Cir. 2000). The Eleventh Circuit went on to say that, where a cash balance plan credits an investment rate of return, projecting future interest credits based on a single year's investment performance would be inappropriate. *Id.* at 1248 n.23 (in such a case, “it would be foolhardy for a plan to base future annual interest credits on any single year's performance of a market index or indicator”).

The final regulations should recognize this fundamental difference and not require projection at a rate that bears no relation to the value of the future interest credits in a plan that credits an investment rate of return.

Instead, the final regulations should expressly recognize that there is more than one rate that can reasonably reflect the value of future interest credits. Moreover, the final regulations should not require a projection rate that fluctuates from year to year. At the very least, the final regulations should

² Moreover, as underscored in our prior submissions, administrative concerns support using a stable projection rate for bond yields that does not change from year to year, except perhaps to reflect long-term, multi-year trends in the bond markets. The same administrative concern for stability applies to any projection rate for investment returns as well.)

³ This means the nominal value of the investment would be expected to change at the current time value of money, not the investment's most recent rate of return. This is, in fact, exactly how futures contracts on securities are priced in the market.

include a safe harbor that deems certain rates to be equivalent to one another. For example, a plan that credits interest at a full market rate (such as the rate of return on plan assets) should be allowed to project at any other rate that is deemed to be a maximum market rate of return--such as the maximum permitted fixed rate (currently 5%).

The approach suggested above is far better than the proposal to assume a rate of zero when the prior year's return is negative. First, the approach ensures that the backloading test measures accruals that have a reasonable relationship to the benefit the participant has actually earned. Second, the approach is consistent with Notice 96-8's requirement to use a projection rate that reasonably reflects the value of future interest credits. Third, the approach obviates the need to create a "fix" that is not clearly authorized by the statute.

Moreover, requiring a projection of investment-based credits at the prior year's rate of return would make it virtually impossible to comply with other technical qualification requirements—making the guidance on investment-based interest credits moot. For example, suppose the rate of return in year 1 is positive 20% and the rate of return in year 2 is negative 20%. (From 2008 to 2009, the S&P 500 and other permitted market rates of return were even more volatile than this.) The maximum account balance permitted by section 415 would shrink dramatically in year 2—possibly resulting in a forfeiture for some participants. The final regulations should not allow a projection rate that yields results like that.

(Please note that whatever projection rate is adopted should be used for projection purposes only and should not result in a fixed benefit promise that cannot later decline. This is how the anti-backloading rules have been administered for decades. And Notice 96-8 has consistently been interpreted this way for any projection rate that meets the Notice's requirement of reasonably reflecting the value of future interest credits.)