SUMMARY AND COMPARISON OF LEADING HYBRID PENSION PLAN REFORM PROPOSALS

[Note: A shaded cell indicates that the version of H.R. 2830 that passed the House on December 15, 2005 (the "Managers' Amendment") included changes to the bill originally reported by the Ways & Means Committee and the Education & Workforce Committee.]

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OVERVIEW					
SCOPE OF PROSPECTIVE RULES	With the exception of limited regulatory guidance, current law does not include specific rules governing hybrid plans, such as cash balance plans and pension equity plans (PEPs). Instead, hybrid plans are subject to the rules generally applicable to defined benefit plans.	Provides specific rules for converting to cash balance plans, applying the age discrimination requirements to cash balance plans, and determining minimum lump-sum distributions from cash balance plans. Indicates that similar rules would be provided for other types of hybrid plans.	Modifies the age discrimination rules applicable to all defined benefit plans and provides specific age discrimination rules for certain plan designs (e.g., offset plans). Provides specific rules for determining minimum lump-sum distributions from cash balance plans.	Same as Administration proposal. Also provides interest crediting requirements and special vesting rules for cash balance plans. Indicates that Treasury may provide similar rules for other types of hybrid plans.	The proposals make only passing mention of PEPs, which would be addressed largely through the regulatory process. PEPs would, however, be covered by the House bill's modification of the general age discrimination rules.
TREATMENT OF EXISTING PLANS	Over the past 20 years, numerous companies have converted their traditional defined benefit plans to hybrid plans. According to the PBGC, there are more than 1,500 of these plans as of 2003 providing benefits to more than 8 million participants. Although hybrid plans have been repeatedly blessed by the Treasury Department and the IRS and were affirmed as lawful by courts on numerous occasions, in *Cooper v. IBM*, a federal district court in 2003 held that the cash balance and pension equity plan designs were age discriminatory because pay credits to younger	All elements of the proposal would be effective on a prospective basis only (presumably following date of enactment). *No inference language.* Provides that "[n]o inference is intended as to the status of cash balance plans or cash balance conversions under current law."	Effective on a prospective basis for periods beginning on or after June 29, 2005.	Generally effective on a prospective basis for periods after July 31, 2005. *No inference language.* States that "Nothing in the amendments made by this section shall be construed to infer the proper treatment of cash balance plans or conversions to cash balance plans under [the age discrimination rules] as in effect before such amendments."	All 3 proposals would clarify the legality of cash balance plans on a going-forward basis, raising the specter of liability for existing plans and prior conversions. The no inference language in the Administration proposal and the Senate bill is intended to avoid the suggestion that existing plans and prior conversions are problematic. However, some commentators have suggested that, as a practical matter, the no inference language will be of little value and that, on balance, prospective-only legislation will be more harmful than helpful with respect to how current law will be interpreted by the

[1] As part of its budget submissions for FY 2005 and 2006, the Bush Administration released a legislative proposal to address a number of hybrid plan issues.

[2] H.R. 2830, The Pension Protection Act of 2005, was approved by the full House on December 15, 2005. The final House-passed language was a managers' amendment that merged and amended versions of the bill previously reported by the Education & Workforce Committee in June, 2005 and the Ways & Means Committee in November, 2005.

[3] S. 1783, The Pension Security and Transparency Act of 2005, was approved by the full Senate on November 16, 2005.

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	participants' accounts had more years to earn interest. The *Cooper* decision is on appeal and oral arguments have been scheduled for February 16, 2006.				courts. Although the House bill does not contain statutory no inference language, the Education & Workforce and Ways & Means Committee reports include favorable language addressing the status of existing plans. In this regard, for example, the Ways & Means Committee report states that the "bill applies on a prospective basis because certain issues addressed by the bill are the subject of on-going litigation. However, the Committee views the provision as a clarification; the action of the Committee in clarifying the law should not cast any negative inference on the legality of hybrid plans."
STEADY STATE					
BASIC DESIGN	The Internal Revenue Code (the "Code"), Employee Retirement Income Security Act ("ERISA") and the Age Discrimination in Employment Act ("ADEA") provide that a defined benefit plan is age discriminatory if the rate of a participant's benefit accrual declines on account of age.	Provides that a cash balance plan satisfies age discrimination requirements if the rate of pay credits for older participants is not less than the rate of pay credits for younger participants.	Provides that a defined benefit plan is not age discriminatory if a participant's entire accrued benefit, "as determined as of any date under the formula for determining benefits as set forth in the text of the plan documents," would be equal to or greater than that of any similarly situated, younger individual. States that a plan may calculate accrued benefits "as the present value of accrued benefits projected to normal retirement age, as an account balance, or as the current value of the accumulated percentage	Provides that a cash balance plan that satisfies vesting and interest rate requirements, described below (a "qualified cash balance plan"), does not violate age discrimination requirements merely because the period of time over which interest credits may be made to a participant's account is longer for a younger versus an older participant, provided that the rate of pay and interest credits does not decrease by reason of the attainment of any age.	The Senate bill would amend the ADEA. The House bill would not; however, this omission appears to have been for procedural reasons. The House Managers' Amendment clarified that cash balance plans that express the accrued benefit as either the account balance or the present value of the normal retirement benefit are not inherently age discriminatory. Significantly, the House Managers' Amendment also explicitly provided that pension equity plan designs that use final average pay are permissible.

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			of the employee's final average compensation."		Query why the PEP provision is limited to final average pay designs?
INTEREST CREDITING RATES	No specific provision.	No specific provision.	No specific provision.	Provides that a qualified cash balance plan must provide interest credits at a rate (i) not less than the applicable Federal mid-term interest rate and (ii) not greater than the rate of interest on long-term corporate bonds, as determined on an annual basis. *Special Effective Date*. The interest rate requirements would be effective for plan years beginning in 2007, unless the plan sponsor elects to apply the requirements in 2006.	The interest crediting requirements in the Senate bill would distinguish cash balance plans from defined contribution plans by restricting the extent to which cash balance plans can provide for notional investments that are similar to the investments available under defined contribution plans (e.g., mutual fund investments). The long-term corporate bond rate maximum appears to be the rate that is used to measure pension liability under the Pension Funding Equity Act of 2005 (i.e., the rate used during 2004 and 2005). It is unclear whether and, if so, how the interest crediting requirements under the Senate bill would apply to PEPs.
VESTING	An employee must have a nonforfeitable right to his accrued benefit under a defined benefit plan equal to either (i) 100% of his accrued benefit after five years of service or (ii) 20% of his accrued benefit after three years of service, with such percentage increasing by 20% for each additional year of service up to 100% after 7 years of service.	No specific provision.	No specific provision.	Would require full vesting after 3 years of service under a cash balance plan. *Special Effective Date*. The new vesting rule would be effective for plan years beginning in 2007, unless the plan sponsor elects to apply the requirements in 2006.	It is unclear whether the new vesting rule would apply to pay credits that have already accrued or only to credits accrued after the effective date. It appears that graded vesting would not be permissible under the Senate bill.
LUMP SUMS	Current law provides that the amount of a lump sum benefit paid from a defined benefit plan must be no less than the	Permits the value of a lump-sum distribution under a cash balance plan to be determined as the amount of a participant's	Same as the Administration proposal, but authorizes the Secretary of Treasury to provide rules governing the	Permits the value of a lump-sum distribution under a cash balance plan that satisfies the vesting and interest credit rates	*Above Market Rates of Return*. If a cash balance plan provides for interest credits at an above-market rate, the Administration

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	actuarial equivalent of the normal retirement benefit determined using the statutorily prescribed interest rate and mortality assumptions. In Notice 96-8, the IRS stated that in calculating the amount of a single sum distribution under a cash balance plan, the balance of the participant's hypothetical account must be projected to normal retirement age using the plan's interest crediting rate (if interest credits do not depend on continued employment) and then discounted back to present value using the statutorily prescribed rate. If the rate used by a plan to project forward exceeds the statutory discount rate, the present value of the accrued benefit will exceed the participant's account balance. If the plan pays only the account balance, some courts have concluded that this is an impermissible forfeiture. This is often referred to as "whipsaw."	hypothetical account balance so long as the plan does not provide interest credits in excess of a market rate of return. The Secretary of Treasury is authorized to provide safe harbors for market rates of return.	calculation of a market rate of return and permissible methods of crediting interest to participant accounts (including fixed or variable interest rates).	requirements to be determined as the amount of a participant's hypothetical account balance.	proposal and the House bill would require the plan to adhere to the methodology outlined in Notice 96-8 and, therefore, potentially pay lump sums in excess of the account balance. The Senate bill would, however, condition relief from the age discrimination rules upon satisfaction of the interest crediting requirements and therefore effectively bars above market rates of return. *Market Rates of Return*. There are a number of questions about the market rate of return requirement in the House bill, including whether a market-based variable crediting rate with a floor on rates of return would be considered above market because of the floor. Treasury regulations under Code section 3121(v)(2) provide guidance on market rates of return, which suggests that "market" could be construed narrowly. In addition to variable rates of return, which were permitted under earlier versions of the House bill, the House Managers' Amendment also authorizes Treasury to provide rules that permit the use of fixed rates of return under cash balance plans. *Equity Rates*. There are a number of open questions under current law about equity rates of interest in cash balance plans, including whether a cash

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					balance plan may permit declines in a participant's account balance. The Senate bill would clearly prohibit equity rates of return by establishing a maximum and minimum crediting rate. The House bill would not expressly bar equity rates of return but also does not address any of the current open issues.
CONVERSIONS					
MANDATES	Although conversions are done in a variety of ways, a typical conversion involves assigning a participant an account balance under the new cash balance plan based on the value of the participant's benefit under the traditional pension plan. On a going forward basis, participants in the cash balance plan receive pay credits and earn interest on their entire account. Some participants in certain conversions, typically older or longer-service participants, have expressed concern that they will receive a pension benefit that is less than they expected under the traditional defined benefit plan formula. Current law does not protect employee expectations but does provide participants with two protections. First, ERISA section 204(h), which was strengthened in the 2001 tax act, requires comprehensive advance notice of a reduction in the rate of benefit accrual.	For the first five years following conversion to a hybrid plan, benefits earned by all participants must be at least as valuable as the benefits participants would have earned under the traditional defined benefit plan had the conversion not occurred. The five-year transition requirements would not be required if plans either "grandfather" all current participants at the time of conversion under the traditional formula or provide that all participants may choose between the traditional defined benefit plan formula and the cash balance formula. Failure to follow the conversion rules will not result in plan disqualification. However, the plan sponsor is generally subject to a 100-percent excise tax imposed on any difference between required benefits and benefits actually provided as a result of	No provision. The current law 204(h) notice requirement and prohibition against reductions in accrued benefits would, however, apply to conversions.	Provides that a defined benefit plan that is converted to a hybrid plan must satisfy one of the following three transition requirements: 1. *The Five-Year Transition Requirement:* The plan must prohibit wear-away for all participants with respect to normal and early retirement benefits <u>and</u> provide either: (i) that for the first five years following conversion, benefits earned by all participants must be at least as valuable as the benefits that would have been earned under the traditional defined benefit plan formula, or (ii) in the case of participants who, at time of conversion, were at least age 40 and had combined age and service of at least 55, the plan provides participants with (a) the greater of the benefits determined under the old or new formula or (b) the right at the time of conversion to elect benefits determined under the old or new formula;	One question under the Senate bill is the extent to which using a transition approach involving choice or "greater of" restricts subsequent benefit changes. The Senate bill indicates that a significant reduction in the rate of benefit accrual within 5 years of a conversion involving choice results in affected participants receiving "greater of" benefits. However, the Senate bill is silent on the downstream implications of a "greater of" conversion and, even for choice conversions, does not clearly provide that changes are permissible after the 5-year hold harmless period. The Senate bill makes clear that a "greater of" transition would also have to take into account early retirement benefits. In applying the Equivalence Approach, there are some questions as to how to value the benefits that would have been earned under the

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	Second, both ERISA and the Code provide that a participant's accrued benefit for services already performed may not be reduced.	the conversion. The amount of the excise tax cannot exceed the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income, whichever is greater.		2. *The Greater of/Choice Approach:* Provide that all participants who were covered under the traditional plan formula at the time of conversion with (a) the greater of the benefits determined under the old or new formula, or (b) the right to elect at the time of conversion benefits determined under either the old or new formula; or 3. *The Equivalence Approach:* Provide additional credits or additional opening account balances in amounts substantially equivalent to the benefits that would be provided in complying with the Five-Year Transition Requirement or the Greater of/Choice Approach. *Effective Date.* Effective for conversions pursuant to a plan amendment adopted and effective after July 31, 2005, although employers could elect to apply S. 1783 to conversion amendments adopted before July 31, 2005 and effective after such date.	traditional defined benefit plan. In addition, it is far from clear how to value choice options, which would appear to be required under the Equivalence Approach. Under all of the proposals, current law's 204(h) notice requirement and prohibition against reductions in accrued benefits would continue to apply to conversions. At times, some regulators have suggested that greater of conversions violate the Internal Revenue Code prohibitions against back-loading of benefits. The Senate bill implicitly rejects this interpretation. The House bill, however, does not address this issue. Many transition benefits – such as choice or greater of – can create problems under the nondiscrimination rules because the employees receiving the transition benefits tend to be higher paid after several years. The Senate bill partially addresses this issue with respect to required transition benefits. If, however, a plan provided transition benefits beyond those mandated – such as greater of benefits provided on an indefinite basis – the bill's protection would not apply. The House bill does not address this issue.

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SPECIAL RULES FOR CHOICE	No specific provision.	No specific provision.	No specific provision.	If a plan chooses a conversion method which provides a participant with a choice between plan formulas, the plan must do the following: 1. *Notice*. The plan must provide notice of the right to make the election, and such notice must include information (1) which permits the participant to project benefits under the formulas and "model the impact of such choice," and (2) which states those circumstances under which a participant may not receive the projected accrued benefits. 2. *Subsequent Changes*. The plan must provide that if, during the 5 years after a participant's election, a plan amendment results in a significant reduction in the rate of future accruals, the accrued benefit of the participant is determined as if the participant had made the election which would have resulted in the greatest accrued benefit. 3. *Anti-Conditioning Rule*. Provides that a plan shall not be treated as complying with the conversion requirements if any other benefit (e.g., enhanced defined contribution plan contributions) is directly or indirectly conditioned on a participant's election.	The prohibition against linking other benefits, such as enhanced defined contribution plan contributions or retiree medical benefits, to a conversion choice is inconsistent with the manner in which many choice conversions have been done.
BENEFIT PLATEAUS	A benefit plateau or "wear-away" results where a	Prohibits benefit plateaus of normal and early retirement	No specific provision.	Provides specific provisions addressing conversions to cash	Under the House bill, ERISA would continue to require

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(AKA "WEAR-AWAY")	participant does not accrue additional benefits under the defined benefit plan until the hypothetical balance under the cash balance plan exceeds the participant's frozen accrued benefit under the traditional formula. Benefit plateaus generally arise in conversions (1) when the opening account balance under the cash balance formula is based on the normal retirement benefit and a participant has accrued (or will accrue) an early retirement subsidy under the traditional plan formula or (2) when a sponsor translates the previously accrued benefit under the traditional defined benefit formula into an opening cash balance account using an interest rate higher than the rate used for purposes of determining minimum lump sum values.	benefits in connection with a conversion to a cash balance plan. As with a plan's failure to follow the five-year conversion rule, failure to follow the wear-away rule would not result in plan disqualification. However, the plan sponsor would generally be subject to a 100-percent excise tax imposed on any difference between required benefits and benefits actually provided.		balance plans, some of which prohibit benefit plateaus. Generally permits benefit plateaus in connection with conversions that use the Choice approach.	advance notice of any benefit plateaus, which are considered reductions in the rate of future benefit accruals, and would bar reductions in a participant's accrued benefit.
INCLUSION OF EARLY RETIREMENT SUBSIDIES	To help address the expectations of some participants regarding the retention of early retirement subsidies under the prior traditional plan, some sponsors have chosen to include some or all of the value of early retirement subsidies in employees' opening hybrid plan account balances. Some regulators have suggested that including early retirement subsidies in the opening account balance is problematic under the pension age discrimination rules because younger workers who are early	Including the value of early retirement subsidies in opening account balances in connection with a conversion would be permitted.	Provides that "the subsidized portion of any early retirement benefit (including any early retirement subsidy that is fully or partially included or reflected in an employee's opening balance or other transition benefits) shall be disregarded" in applying the age discrimination requirements.	Provides that if any early retirement benefit or retirement-type subsidy is not included in the initial account balance in a conversion, the plan has to credit such amount when a participant retires and becomes entitled to such benefit or subsidy.	The House bill appears to bless the inclusion of credits as a permanent part of opening account balances to reflect all or part of the value of early retirement subsidies. It is not clear whether the omission of this provision in the Senate bill reflects the considered view of the Senate that building early retirement subsidies as a permanent part of the opening account balance is age discriminatory, as suggested by some pension regulators under current law. The "pop-up" provision in the

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	retirement eligible often have more valuable early retirement subsidies than older workers.				Senate bill appears to entail more than merely preserving protected early retirement benefits.
BEYOND HYBRIDS					
	Some have suggested that, for the same reasons hybrid plans were found to violate the pension age discrimination rules in *Cooper*, certain other plan designs that incorporate a time value of money feature may also run afoul of the pension age discrimination rules. In this regard, for example, questions have arisen about the legality of certain floor offset plans, plans that provide for pre-retirement indexing of benefits, and contributory plans.	No specific provision.	Provides safe harbor rules under the age discrimination rules of ERISA and of the Code for defined benefit plans that provide for certain "allowable offsets" (e.g., Social Security), plans that satisfy the requirements of section 401(l), and plans that provide for retirement indexing. Indicates the indexing cannot result in a decline in a participant's accrued benefit and defines indexing to means the periodic adjustment of a benefit by means of a recognized investment index or methodology.	No specific provision.	Although the House bill creates safe harbor rules for plans with certain features, such as offsets, permitted disparities and retirement indexing, it does not address all plan features. Although presumably unintended, the absence of an exhaustive list could be construed to suggest that these other plan features do not satisfy the age discrimination requirements. The House Managers' Amendment expanded the provision in earlier versions of the House bill addressing pre-retirement indexing. As amended, the House bill applies to both pre-retirement and post-retirement indexing. In connection with this change, the House Managers' Amendment also provided that indexing cannot cause an accrued benefit to decline. Query whether equity rates of return would be considered "indexing" and therefore cause a plan to lose the benefit of the safe harbor?

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