**Excerpts from Statements Regarding Hybrid Plans During August 3, 2006 Senate Debate on H. R. 4, The Pension Protection Act of 2006**

**KENNEDY**:

Our legislation also addresses new types of pensions, like "hybrid" pensions, which play a growing role in our retirement system. These pensions provide a guaranteed pension, and the benefits are attractive to younger workers and to others, such as parents caring for children, who move in and out of the workforce. Older workers, however, can lose out when their companies switch to these plans because they lose a large portion of the benefits they were promised. Some companies have been taking advantage of the conversion process to eliminate early retirement benefits that workers have already earned.

This legislation gives companies clear guidance about the future legal status of these plans, but allows workers who have been harmed in the past to continue to pursue their rights. And it contains clear protections against such "wearaway" or erosion of older workers' benefits. The bill also makes these pensions more portable, so that they better serve a mobile workforce.

**ENZI:**

The legality of cash balance and other hybrid pension plan designs is clarified on a prospective basis under ERISA, the Internal Revenue Code, and the Age Discrimination in Employment Act, thus ending legal challenges that have driven hundreds of quality employers out of the defined benefit system. We have always felt that these plans are valid under the Code, ERISA and the ADEA.

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One of my highest priorities for pension reform is clarification of the legal status of hybrid pension plans. Since late in 1998 when sensational stories about these plans first hit the newspapers, the Congress has been struggling over how to respond. I have never doubted the legality of hybrid plans. While some conversion practices may have been questioned, the plans are entirely valid. Hybrid plans have been criticized on the theory that the design was per se discriminatory. The theory suggests that the hypothetical individual account plan design unlawfully favors younger workers over older ones because younger workers could accrue interest on their account over a longer period of time than older workers. This theory amounts to a declaration that the "time-value of money" is age discriminatory.

Not surprisingly, given the confused logic of stating that compound interest in a pension plan is age discriminatory, most courts that have reviewed the age appropriateness of hybrid plan designs have found them to be legitimate. Indeed, the first federal court to review the question stated "Plaintiffs' proposed interpretation would produce strange results totally at odds with the

intended goal of the OBRA 1986 pension age discrimination provisions (Eaton v. Onan (S.D. N.Y. 2000))." The case law validating the hybrid design includes three federal court decisions issued since a 2003 rogue decision in the Southern District of Illinois. These decisions explicitly reject that court's reasoning and conclusion (Tootle v. ARINC (D. Md. 2004), Register v. PNC (E.D. Pa. 2005) and Hirt v. Equitable (S.D. N. Y. 2006) and hold the hybrid pension design to be legal. Consistent with these numerous federal court decisions, the Internal Revenue Service (IRS) for 15 years issued approvals for individual cash balance plans and the Treasury Department and IRS repeatedly issued guidance as to the validity of the cash balance design. It is not time for the IRS' self-imposed moratorium on determination letters for sponsors of these plans to end.

For purposes of applying the age discrimination test, the bill permits a plan to express an employee's accrued benefit "under the terms of the plan" as an account balance or current value of the accumulated percentage of the employee's final average compensation.This rule was intended to limit, for purposes of age discrimination testing, the use of an account balance to cash balance plans and the use of a current value to pension equity plans. However, the phrase "under the terms of the plan" could create the impression that the rule applies only to cash balance and pension equity plans that define in the plan document the term "accrued benefit" in this way.

Many cash balance and pension equity plans define "accrued benefit" as an age-65 annuity, even though that annuity is determined by reference to an account balance or current value. In many cases, this definition has been required by the Internal Revenue Service. It is important to clarify that Congress does not intend to require a plan document to include a specific definition of the term "accrued benefit" to apply the standard set forth in this legislation.

This bill sets forth a test for age discrimination in defined benefit pension plans that compares an employee's accrued benefit with that of any similarly situated younger employee. For this purpose, an employee's accrued benefit may be expressed as the current balance in a hypothetical account for any plan that determines the employee's accrued benefit (or any portion thereof) by reference to a hypothetical account, such as a cash balance plan. Similarly, for this purpose, an employee's accrued benefit may be expressed as a current value equal to an accumulated percentage of the employee's final average pay for any plan that determines an employee's accrued benefit (or any portion thereof) by reference to such current value, such as a pension equity plan.

But the bill does not elevate form over substance. How a plan expresses the accrued benefit for purposes of the age discrimination rules is not contingent upon how the plan document defines the term "accrued benefit." For example, a cash balance plan may, for purposes of the age discrimination rules, express the accrued benefit as the current balance of the hypothetical account determined under the terms of the plan, even if the plan defines the term "accrued benefit" in a different form, such as an annuity commencing at normal retirement age that is based on the hypothetical account.

Similarly, a pension equity plan may express the accrued benefit as a current value equal to an accumulated percentage of the employee's final average pay as determined under the terms of the

plan, even if the plan defines the term "accrued benefit" in a different form, such as an annuity commencing at normal retirement age that is based on that current value. This flexibility is important because pension plans will often define the "accrued benefit" in different fashions. For example, the IRS has frequently insisted that plans define the term "accrued benefit" as "an annuity commencing at normal retirement age", even though the annuity is determined by reference to a hypothetical account or a current value equal to an accumulated percentage of an employee's final average pay.

Any hybrid plan including a cash balance or pension equity plan may also apply the age discrimination test by expressing the employee's accrued benefit as an annuity beginning at normal retirement age (or at the employee's current age, if later), as determined under the terms of the plan. If a cash balance or pension equity plan were to do so, it likely would rely on the indexing rules elsewhere in section 701 to satisfy the age discrimination test.

The pension reform bill also provides new specifications for hybrid plan conversions. These are entirely new requirements and they have been worked out among the parties to these discussions. The rule specifies that for conversions, plans should follow an "A + B" formula. This means that the benefit accrued to date under the old formula, that was in effect prior to the conversion, must be added to the benefit under the new formula beginning on the date the conversion takes effect.

Under this A + B formula, any early retirement subsidy that was accrued up to the date of the conversion would be preserved in the benefit of the participant. This early retirement benefit would be payable only if the participant earned the requisite number of years of service to entitle him or her to the benefit subsidy. The participant would not be entitled to any additional amount of subsidy, but only the amount earned to-date could be paid out and only assuming he or she worked the number of years required under the plan to earn it. The new rule does not require a plan to pay an early retirement subsidy in lump sum unless the plan provides that it will do so. This is consistent with current law and practice.

The hybrid language also corrects the so-called pension whipsaw for distributions after the date of enactment. The parties to the pension discussions took the view that the position taken by the IRS in Notice 96-8 was an incorrect interpretation of present law. Many of us who were engaged in the pension reform discussions noted that Notice 96-8 was never finalized by the IRS in their regulations and we observed that the Treasury Department had been reviewing the position in Notice 96-8 for some time, but without result.

The approach taken in Notice 96-8 can actually harm many participants. Many employers have reduced the rate of interest crediting under their hybrid plans due to concerns that over the requirements of the notice. In addition to its other flaws, the approach taken in the notice provides a larger benefit to be paid to a participant who takes a distribution before normal retirement age than for a participant who waits to take his or her benefit distribution. Thus Notice 96-8 would penalize an employee who waits to take a distribution. This is a perverse result for a rule governing retirement plans.

As we developed these new rules for hybrid plans, we were cognizant that the system is voluntary and as such, it must accommodate the needs and concerns of employers and

employees. A viable pension system must grant plan sponsors the ability to change their plan designs on a prospective basis without undue restrictions or mandates on benefit levels.

This legislation is a clarification of the law; the action in producing this clarification should not cast any negative inference on the legality of the hybrid plans.

**BURR/ENZI COLLOQUY:**

section 701

Mr. BURR. Mr. President, I would like to ask the chairman of the Committee on Health, Education, Labor, and Pensions a question regarding how section 701 of the new bill relates to capital preservation and loss protection. Would you please explain what types of plans are subject to each of the two rules and how the rules operate?

Mr. ENZI. The capital preservation rule applies to applicable defined benefit plans, such as cash balance and pension equity plans. To illustrate how the rule operates in the case of a cash balance plan, the rule requires that the cumulative effect of all the interest credits to an employee's hypothetical account may not reduce the account balance below the sum of all the pay credits made to the account.

Mr. BURR. The bill refers to "contributions credited to the account" rather than pay credits?

Mr. ENZI. Yes. The two terms are synonymous. Since the account in a cash balance plan is hypothetical, the contributions credited to it are hypothetical also. Hypothetical contributions is merely another name for pay credits.

The second rule, the loss protection rule, applies to all defined benefit plans that use any form of benefit indexing. Thus, the second rule applies not only to cash balance and pension equity plans but also to other defined benefit plans that index benefits.

The loss prevention rule would apply in the same way as the capital preservation rule in the above example of a cash balance plan. However, because the loss prevention rule applies to a broader group of plans than just applicable defined benefit plans, the rule is written in more general terms than the capital preservation rule, which applies to a narrower universe of plans.

To illustrate how the loss protection rule operates in the case of a defined benefit plan that indexes benefits by reference to changes in the Consumer Price Index, the rule requires that the cumulative effect of such indexing may not cause a decrease in an employee's benefit below what it would have been in the absence of such indexing. Although it is very unlikely, this would occur if there were a sustained period of deflation in which the overall change in the CPI were negative rather than positive. In that extremely unlikely case, the plan could not reflect the cumulative negative change in the CPI.

Mr. BURR. At what point are the rules applied?

Mr. ENZI. The capital preservation and loss protection rules are intended to provide long-term protection to employees, so the determination of whether the rules are satisfied is made at the time benefits commence but not beforehand. In the case of plans that index benefits after benefits begin, the determination is made by reference to the benefit in effect at the time benefits begin.

**GREGG/ENZI COLLOQUY:**

lump sums from hybrid pension plans

Mr. GREGG. Mr. President, I would like to ask the chairman of the Committee on Health, Education, Labor, and Pensions, to clarify provisions of H.R. 4 that address the payment of lump sums from hybrid pension plans.

My first question relates to a clarification of the effective date of those provisions. As you are aware, under the so-called whipsaw method of calculating lump sums, younger workers would receive much larger lump sums than identically situated older workers.

This result is one that Congress never intended. Furthermore, the practical effect of the whipsaw calculation would be to reduce benefits for all participants, young and old, in cash balance plans. Therefore, the intent of the whipsaw provisions is to put this issue to rest. Accordingly, the provisions are effective for distributions made after the date of enactment, regardless of why they are made.

Mr. ENZI. Yes. The provisions do apply to all distributions made after the date of enactment.

Mr. GREGG. My second question relates to the definition of "market rate of return" in the whipsaw provisions. My understanding is that the term "market rate of return" is intended to allow plans to adjust benefits in ways that benefit participants. For example, a plan could provide a variable market rate of return and, in addition, protect participants by preventing the rate of return in their accounts from falling below a reasonable, minimum level without having to reduce the variable market rate of return. My further understanding is that the term "market rate of return" is intended to include a fixed rate of interest that is no greater than the yield on long-term, investment-grade corporate bonds at any time during a reasonable period before the rate is first applied under the plan; is this correct?

Mr. ENZI. Yes, it is.

**BAUCUS:**

Second, let me address cash balance plans. We have been struggling with the difficult problems of a new form of defined benefit plan called a "cash balance plan" for many years. Most pension experts recognize the cash balance design and other hybrid plan designs as the future of the defined benefit system. And that future is in limbo until we provide certainty as to the governing rules. Yet there is a real concern about age discrimination and what happens to workers who get caught up in the switch from a traditional plan to a cash balance plan.

This bill once again strikes a balance. It is a balance that is not likely to make anyone completely happy. We have dealt with the law going forward. We intend no inference to what the rules were prior to enactment. We will leave the past to the courts.

But in the future, employers and workers will know the guiding principles. I expect that as a result, we will see new life in the cash balance world. And we also make sure that workers are protected.