AMERICAN ACADEMY *of* ACTUARIES

January 12, 2011

CC:PA:LPD:PR (REG–132554–08)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Additional Rules Regarding Hybrid Retirement Plans

To Whom It May Concern:

The American Academy of Actuaries[1] Pension Committee respectfully requests your consideration of its comments regarding the proposed regulations for hybrid retirement plans (REG–132554–08). The Committee appreciates the opportunity to comment on the proposed regulations as well as the series of thoughtful questions posed to respondents. Also included in this letter are some items of concern for which we believe the proposed regulations may lead to undesirable consequences or unintended results.

Rate of Return

Statutory hybrid plans are defined benefit plans and thus, for purposes of nondiscrimination and backloading tests, are required to define a benefit in terms of an annuity. Current conventions for some of the annuity conversion calculations can produce unreasonable results.

<u>Nondiscrimination</u>

In testing a defined benefit plan of any kind on a contributions basis, benefits must be converted to an allocation using a standard interest rate of between 7.5 percent and 8.5 percent. Some also have employed the convention of using the most recent interest crediting rate, which will often fall outside of this range, as the assumed interest crediting rate for future periods, regardless of how this rate compares with reasonable expectations of rates for future periods. The combination of these factors can produce results that do not make sense.

Consider, for example, a cash balance plan that credits a reasonable market rate of interest. Assume that, for the most recent year, this rate resulted in a 2 percent interest credit. In converting a $5,000 pay credit to an equivalent contribution (and ignoring the impact of differences in the plan's conversion mortality table and a standard mortality table under the regulations) the pay credit would be projected to normal retirement at 2 percent and discounted back to current age at 7.5 percent (or as high as 8.5 percent). For a participant age 25 with a normal retirement age of 65, the $5,000 pay credit is treated as equivalent to a defined contribution (DC) contribution of $612. This outcome is

[1] The American Academy of Actuaries is a professional association with 17,000 members, whose mission is to assist public policymakers by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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not an accurate reflection of the relative value of the two benefits under any reasonable scenario and could lead to significant potential abuse of the nondiscrimination testing rules.

To remedy this situation, we recommend that the testing rules be updated for cash balance plans. We specifically recommend that if the plan credits interest at a reasonable market rate of interest, then the same rate should be used for purposes of projecting and discounting in all normalization calculations. If a plan credits interest at a rate that is a reasonable market rate less a specified margin, then the projection rate should be less than the discounting rate by that margin. This approach would preserve the fundamental economic equivalence between the cash balance plan and a comparable contribution to a defined contribution plan.

This suggestion can be implemented in one of two ways:

1) The ideal approach would be to update the nondiscrimination testing rules to specify the use of alternative reasonable interest rates. Such an approach would fit within the existing nondiscrimination testing framework, which specifies, in the definition of standard interest rate, that "the Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard interest rate."
2) An interim alternative, which might fit better in the context of hybrid plan guidance, would be to specify that solely for purposes of nondiscrimination testing for a statutory hybrid plan, in cases in which the plan's interest credit rate is a reasonable market rate, the assumed interest credit should be equal to the same standard interest rate that is used for other nondiscrimination testing calculations (or the standard rate less a margin if the plan's rate is less than a market rate by a specified margin).

Currently the regulations define maximum rates that can be used without violating Internal Revenue Code Section 411(b)(5)(B)(i) prohibition on rates in excess of a market rate of return. The above suggestions would require determining which of these rates is considered to be a reasonable market rate. We recommend that any of the Treasury yields (with or without margin), or any of the other maximum rates defined in the final or proposed regulations, be treated as market rates for this purpose. The addition of an annual or cumulative minimum interest credit would not affect this definition.

General Backloading Comments

As discussed in further detail later in this letter, the historical approach to demonstrating that a cash balance plan complies with the backloading rules of Section 411(b)(1) —and the approach described in Revenue Ruling 2008-7—is to show that the plan would satisfy the accrual rules based on any possible interest crediting rate. This approach could require a plan to introduce a minimum interest crediting rate solely to demonstrate compliance with the accrual rules, even if the minimum interest rate never would have applied in any previous year and is not expected to apply in any future year.

We believe the IRS should consider other reasonable approaches to demonstrate compliance with the backloading rules, such as the use of a single fixed, long-term rate. This would allow plan sponsors to disregard differences in interest crediting rates that are due solely to the different risk premiums associated with different market instruments, and would ensure that cash balance plans are not put at an unreasonable disadvantage relative to defined contribution plans.

411(a)(9) Requirement

The proposed regulations do not address the effect of IRC Section 411(a)(9), which defines the normal retirement benefit as being the greater of the early retirement benefit or the benefit commencing at normal retirement age on statutory hybrid plans. We understand this requirement has been interpreted by some as requiring that a plan keep track of the annuity potentially payable at every possible commencement age prior to normal retirement to ensure that the annuity payable at normal retirement is no less than this amount. Such an interpretation would make cash balance and other similar plan designs impractical from the point of view of a plan sponsor, inflating costs and greatly complicating administration.

Another alternative would be to apply this requirement at each early retirement age on a prospective basis. This prospective test would be applied assuming that current annuity conversion interest rates remain unchanged and could require a demonstration that 411(a)(9) is satisfied based on any possible interest credit rate of 0 percent or higher. Such a test would meet the goal of 411(a)(9), which is to ensure that an early retirement subsidy does not cause the early retirement benefit to exceed the benefit the participant can expect to receive at normal retirement—thereby exert undue pressure on the employee to terminate employment.

Consider the following example:

A participant currently age 64 has an account balance of $100,000. Assuming the segment interest rates are all 6 percent, and the conversion is based on 417(e) assumptions for 2011, the annuity payable at age 64 would be $8,815 per year. The current-year pay credit is $4,000 and the interest credit rate is 2 percent, resulting in an age 65 account balance of $106,040. If the segment rates remain at 6 percent, the age 65 annuity would grow to $9,578. Even if the additional pay credit is disregarded, the annuity would increase to $9,182. But if the segment interest rates drop by 1 percent (to 5 percent) the annuity at age 65 would be only $8,783, which is less than the age 64 annuity.

If the plan credits accounts based on actual fund return or mutual fund returns, the interest credit could be negative in any year. Assuming that the interest credit is -5 percent instead of 2 percent, this would result in an age 65 account balance of $98,900 and an age 65 annuity of $8,192—well below the age 64 annuity.

Requiring payment of the higher annuity would make the cash balance plan considerably more costly than a comparable DC plan, and would result in a significant difference between the value of the annuity and lump sums offered under the plan. It also would make it difficult for plan sponsors to manage risk effectively and thus could encourage sponsors to abandon defined benefit (DB) plans entirely in favor of DC plans. These results are contrary to the intent of the Pension Protection Act (PPA) cash balance rules. Having to calculate the early retirement annuity at every monthly calculation date also would complicate plan administration.

The prospective test suggested above would protect the participant's reasonable expectations for future annuity amounts, determined as of the date the age 64 annuity was available, since the age 65 benefit using the 6 percent conversion factors is higher at all crediting rates 0 percent and higher. From this perspective, the test preserves the intent of 411(a)(9).

On the other hand, a retrospective application of this requirement would provide a more predictable retirement income stream for participants who are trying to plan for retirement. The prospective test, combined with an equity-based return, could make the retirement benefits, expressed as an annuity, quite volatile.

An intermediate approach also might be considered. Such an approach would address retirement planning concerns but avoid one-sided changes in plan costs that prevent plan sponsors from managing the associated risks. One option would be to allow the prospective approach, but only if a participant who has reached a reasonable early retirement age is given the opportunity to elect to annuitize some or all of the account balance at then-current annuity conversion rates. The participant would not be forced to make this election, but the offer of this option to the participant should be sufficient to eliminate retrospective application of 411(a)(9). This is because the participant would not have to retire in order to be able to take advantage of the conversion rates in effect at early retirement. This option, therefore, would offer full protection of the early retirement annuity or an actuarially equivalent amount. The commencement date would not have to be specified at the time of the election, but rather an actuarially equivalent schedule of benefits by commencement age would be developed. Payment then would commence at the earliest date permitted under the plan (to limit the possibility of antiselection) in the form of a non-417(e) annuity. There would be no need to offer this option to a terminated vested participant who already has the right to immediate commencement of payments or to any participant who has the right to immediate commencement of payment.

Questions Posed to Respondents

1) *Should a defined benefit plan that expresses a participant's accumulated benefit as a current single-sum dollar amount and that does not provide for interest credits be excluded from the definition of a statutory hybrid plan?*

We believe that a DB plan that expresses a participant's accumulated benefit as a single-sum dollar amount and that does not provide for interest credits should be excluded from the definition of a statutory hybrid plan. It is important to note that, in most cases, such plans actually express a participant's benefit as a lump sum payable at normal retirement age—rather than as a current lump sum. Early retirement reductions generally would be applied to the lump sum payable at normal retirement age if a participant were to commence his or her benefit in the form of a lump sum before normal retirement age. Similarly, early retirement reductions would be applied to the annuity benefit payable at normal retirement age if a participant were to commence their benefit as an annuity prior to normal retirement age. The delivery of benefit value to participants in such plans therefore is similar to that in traditional defined benefit plans—the primary difference being that benefits are expressed as a lump sum payable at normal retirement age rather than as an annuity payable at normal retirement age. There is no need to provide interest credits in such plans in the same way and for the same reasons that there is no need to provide interest credits in a traditional DB plan.

A key characteristic of statutory hybrid plans is that benefits are expressed as a current account value to the participant, which potentially could be paid in an immediate lump sum if a participant has terminated employment. The lump-sum amount typically will increase with periodic interest credits if the participant defers receipt of his or her benefit following termination of employment. In other words, the accumulated benefit is expressed as the current value of a single-sum dollar amount regardless of when the participant commences his or her benefit.

In contrast, in plans that express a participant's benefit as a lump sum payable at normal retirement age, the lump sum amount typically remains constant once a participant has terminated employment —in the same manner that the annuity payable at normal retirement age in a traditional DB plan would remain constant. The annuity benefit provided by such a plan may vary if a variable basis such as 417(e) is used to convert the lump sum to an annuity payable at normal retirement age. It is also possible, however, for such a plan to use a fixed actuarial equivalence basis to perform such a conversion.

It is important to note that plans defining a participant's benefit as a lump sum payable at normal retirement age do not present the same age discrimination concerns as plans that provide pre-retirement interest credits. The benefit payable at normal retirement age that is provided to an older participant in such a plan never will be less than the benefit provided to a similarly situated younger participant—whether the benefit is expressed as a lump sum or an annuity. A key reason for the hybrid plan provisions in PPA was the concern that benefit accruals earned by older participants could be less valuable than the benefit accruals earned by similarly situated younger participants. Since these concerns are not present in plans that define a participant's benefit as a lump sum payable at normal retirement age, the PPA hybrid plan provisions should not apply.

Because such plans provide benefit value in a manner similar to traditional DB plans, we believe that they should comply with the same vesting and 417(e) rules that apply to traditional plans. If the traditional plan 417(e) rules apply, then there would be no special concerns regarding "whipsaw relief" for these plans.

If a participant were to elect a lump sum form of payment at normal retirement age, the lump sum would need to be at least equal to the present value of the normal retirement benefit using the plan's 417(e) assumptions. If annuity conversion at normal retirement age is performed using 417(e) assumptions, then the accumulated benefit at normal retirement age automatically will satisfy the 417(e) requirements. If a fixed annuity conversion basis is used, a "whipsaw" calculation would need to be performed.

Prior to normal retirement age, lump sum payments could be determined either by converting the accumulated benefit to an annuity payable at normal retirement age, and then applying the 417(e) assumptions, or by specifying a set of early retirement factors that apply to the lump sum form of payment. If the latter approach is used, the basis for determining the early retirement factors applicable to the lump sum would need to be at least as generous as the plan's 417(e) basis. As in a traditional defined benefit plan, a basis other than 417(e) could be used to determine early retirement annuity benefits based on the normal retirement annuity benefit.

In summary, because the plans described above provide benefit value in a manner similar to traditional DB plans, we believe the final regulations should clarify that the rules applicable to statutory hybrid plans do not apply to such plans, while the traditional plan vesting and 417(e) rules do apply to such plans.

2) *In the case of a statutory hybrid plan that credits interest using an interest crediting rate equal to the rate of return on a RIC, how does section 411(d)(6) apply if the underlying RIC subsequently ceases to exist?*

We believe that a plan sponsor primarily should be able to move from one regulated investment company (RIC) to another RIC with only limited restrictions (perhaps restricting a change to once every five years). By definition, the return on all RICs are "market rates of return" because all truly are market vehicles, and investors have elected to accept the returns they offer in consideration of the opportunity for all other alternatives available. If such an availability to switch were broadly granted every five years, the situation in which a RIC has ceased to exist could be handled as an additional opportunity to change.

We do not believe that, over most time horizons consistent with an employee's working career, the presence of a cumulative floor of up to 3 percent materially biases the concept that all RICs offer a market rate of return. But if a further limitation on the ability to change RICs is desired because the cumulative floor is more valuable when returns are more volatile, then it would seem that some type of limitation could be imposed based on the relative volatility of returns. For example, alternative RICs could be limited to those for which the standard deviation of annual returns over a defined period (perhaps five, seven, or 10 years) is within a specified range around the standard deviation of the RIC being replaced. The period under consideration should be no longer than the period during which the RIC being replaced actually existed. As an alternative, a comparable analysis could be performed based on the volatility of the asset classes underlying the RIC—but it may be difficult to define explicit rules that take this into account for all RICs.

We also believe, however, that consideration should be given to a broader extension of flexibility to move between the interest crediting rates specified under Treasury Regulation Section1.411(b)(5)-1(d)(3), (4), and (5). The general thought behind much of the interest crediting regulations is that none of the rates permitted under any of the sections is in excess of a market rate of return. It would seem to be fair, as a result, to permit plan sponsors to move between these rates periodically—perhaps no more frequently than every five years, and perhaps only to rates with comparable (or lower) reduction from the maximum rate for that particular measure. Additional restrictions may be warranted for moving to or from a fixed interest rate or moving away from the second or third segment rates.

3) *The proposed regulations permit certain fixed interest crediting rates (a fixed 5 percent rate for any year, the greater of 4 percent or certain bond-based indices for any year, and a cumulative minimum 3 percent annual rate).*

We support the issuance of regulations that permit the use of reasonable minimum interest credits, in accordance with the terms of PPA, as well as fixed interest crediting rates. We also believe that both the 4 percent minimum and the 5 percent fixed rate should be set at higher levels. We will provide our reasoning below. We support the 3 percent cumulative minimum.

<u>4 Percent Minimum</u>
The statute provides that a plan does not fail to meet the market rate requirements merely because it provides for a reasonable minimum guarantee. In the preamble to the proposed regulations the IRS articulates its thinking behind the proposed minimum of 4 percent, stating "The Treasury Department and the IRS have modeled the historical distribution of rates of interest on long-term investment grade corporate bonds and have determined that those rates have only infrequently been lower than 4 percent and, when lower, were generally lower by small amounts and for limited durations."

We submit that this criterion for selecting a permissible minimum rate is inconsistent with the statute. The statute clearly permits the use of a reasonable minimum. Instead of seeking a reasonable minimum, the stated intention in the regulation is to set a minimum that rarely applies and, when it does apply, has little effect. This is fundamentally inconsistent with the concept of a reasonable minimum.

We note that all varieties of the third segment rate have averaged more than 6 percent for the period for which they have been published and current liability rates have averaged similar levels before PPA. These rates rarely dropped below 6 percent and never dropped below 5 percent. Even the second segment rate has averaged more than 6 percent and only recently has the one-month average second segment rate dropped below 5 percent. As these rates are acceptable as market rates, it easily could be argued that 6 percent is a reasonable minimum to permit. To reflect the IRS' concerns regarding the rate as a whole, however, we respectfully submit that 5 percent should be a permissible minimum annual rate. This better meets that statue's intention of a reasonable minimum—compared to the 4 percent contained in the proposal.

The preamble of this proposed regulation supports the approach by stating that the limited effect of this minimum would permit its use while not causing a rate to exceed a market rate. This approach, however, is also inconsistent with the statute. The statute does not require that an interest credit together with a reasonable minimum must not exceed a market rate. Instead, the statute says that the interest credit must not exceed a market rate and states that the rate will not exceed a market rate merely because of the presence of a reasonable minimum. The approach the IRS has taken directly contradicts the statute's instruction as the preamble indicates that the level has been set so as not to have the rate exceed a market rate merely because of the presence of the minimum. We understand that there must be some assessment of whether the rate with a minimum is a market rate and that the IRS was given this regulatory authority by the statute. But we believe that this proposal as interpreted essentially changes the provisions of the statute.

<u>5 Percent Fixed Rate</u>
Our views on the 5 percent fixed rate are similar to those regarding the 4 percent minimum and we also view the intentions articulated in the proposal similarly. We agree with the approach taken by the IRS by which the permissible level for a standalone fixed rate should be set at a level that is somewhat above the level for a minimum rate to reflect concern about the interaction of the rates.

We believe that the history of the third segment rate and current liability rates before that, as well as broader data on corporate bond yields far exceeding 6 percent for decades before that, suggest that a fixed rate of 6 percent should not exceed a market rate. Any analysis of relevant data will result in the conclusion that a 6 percent rate is not expected to be above long-term corporate yields for anything other than short periods of time.

We understand that there could be a concern that capital markets could change dramatically—and for an extended period—and that it is possible that 6 percent could be above corporate yields, although we suspect few would have said this was possible a mere five years ago. We suggest that this concern should not be addressed by promulgating a permissible fixed interest rate that is conservatively low. We instead suggest that the IRS consider revisiting the issue periodically, every five or 10 years, for example, and make changes in the regulations to the extent there have been substantial changes in the capital markets that warrant such changes. Without such a process, the fixed rate runs the chance of being too high or two low and neither result would be consistent with the intent of the statute.

An example of another regulation regarding interest rates illustrates this issue and raises a concern. The nondiscrimination regulations require the use of a standard interest rate, defined as 7.5 percent to 8.5 percent, to be used for certain purposes. This range likely indicates what the IRS viewed as a reasonable interest rate when these regulations originally were promulgated. It could be argued that the continued requirement to use an interest rate within this range for current testing purposes suggests that these rates remain reasonable and should be viewed as rates that do not exceed a market rate. While we are not suggesting this, we would point out that this fact highlights the need to revisit regulations periodically and revise them when capital market changes warrant a revision. In addition, we would point out that requiring the use of substantially different interest rates for similar purposes will create unnecessary complication and frustration. We urge that the fixed rates that are permissible as interest crediting rates be coordinated in a reasonable manner with other compliance-related interest rates.

<u>Broad Considerations</u>
We encourage the IRS to consider the effect of the rules they will finalize on participant benefits, plan design and administration and plan sponsorship. The lower the rates permitted, the lower participants' benefits likely will be, the more changes to plan design and administration will be required, and the more inclined some plan sponsors might be to exit the system. From our collective experience, we believe fixed rates in excess of 4 percent, and even 5 percent, are not uncommon. We understand that these are not determinative factors and that the IRS must interpret and enforce the statue in a reasonable manner. These factors, however, should be taken into consideration when the IRS decides where within the reasonable range of potential minimum or fixed rates it chooses to set it/them. We believe that the arguments above support the view that our suggested rates are more faithful interpretations of the statute than those proposed. Even if you do not agree with this view, we believe that the arguments above support our suggestions as reasonable, if not better, interpretations of the statue. We also believe that the practical implications of the rules suggest that the service should move toward our suggestions when the regulations are finalized.

4) *Should a statutory hybrid plan be able to offer participants a menu of hypothetical investment options (including a life-cycle investment option, whereby participants are automatically transitioned incrementally at certain ages from a blended rate that is more heavily equity weighted to a rate that is more heavily bond-weighted) and, if so, what plan qualification issues (i.e., forfeiture, section 411(d)(6), market rate of return, and other section 411(b)(5) issues) arise under such a plan design? In particular, do the following events raise issues: (1) A participant elects to switch from one investment option to another; (2) a bond index or RIC underlying one of the investment options ceases to exist; (3) the plan is amended to eliminate an investment option; (4) a participant elects to switch from an investment option with a cumulative minimum to an investment option without a cumulative minimum (or vice versa); or (5) the plan is terminated and, pursuant to the special rules that apply upon plan termination, the interest crediting rate that applies to determine a participant's benefit after plan termination must be fixed?*

We believe that the final regulations should permit a plan to provide a choice to participants of otherwise acceptable crediting rates. Many employees are accustomed to investment discretion through their 401(k) plans. Investment discretion allows individuals more involvement in the retirement planning process for individuals.

Employees of different ages have different time horizons and therefore different tolerances for risk and fluctuations in asset returns. Life-cycle or target-date funds could be appropriate options for participants who would like to choose one option and not change it during their career. Those should not be the only options; any option available to a plan sponsor should be available to a participant.

We believe there should be no requirement for 411(d)(6) protection if a participant chooses to change from one investment choice to another. Since this is the choice of the participant, there should be no requirement for the plan sponsor to track prior investment choices or to credit interest under a prior choice.

If each investment option complies with the market rate of return, then the plan as a whole should comply with market rate of return.

The preservation of capital rule should apply regardless of the participant's choice of investment and regardless of any changes in that choice.

Regarding the five items listed in the question, we have a few comments. 1) As mentioned before, a participant's election to change investment options should not raise any issues. 2) An index or RIC underlying one of the options should be treated the same as it would for the plan as a whole, as discussed in question No. 2 above. 3) The same should hold if a plan is amended to eliminate an investment option. 4) A cumulative minimum applies over the entire period of participation during the plan, rather than just the period that a participant is invested in a particular option (otherwise a cumulative minimum effectively could be converted into an annual minimum, which is otherwise impermissible for a RIC-based return). The cumulative minimum accordingly should apply to the plan as a whole, rather than to individual investment options. Since a cumulative minimum in excess of 0 percent is not required, the sponsor should be permitted to reduce any cumulative minimum (again, on a plan-wide basis) to be no less than 0 percent, subject to 411(d)(6) protection of the old minimum on pay credits already earned. 5) For a RIC-based return with participant choice, a requirement to apply a separate five-year average on each option could lead to unreasonable and inequitable results on plan termination. We recommend that the same rate be used for all participants, regardless of their pre-termination elections. Since whichever rate is credited would be guaranteed and not subject to any risk, we believe it would not make sense to offer different risk-free rates to different participants based on their elections prior to plan termination. Several different reasonable approaches might be used to determine this rate. One option would be to calculate an aggregate average rate for the plan reflecting all participant elections. Another option would be to substitute a default rate, such as the second segment rate.

In addition, a participant's choice of investment option should not affect how a plan passes the accrual rules. Earlier in this letter, we mentioned some appropriate assumptions for testing the accrual rules, which also should apply to any participant-directed plans.

5) How does a statutory hybrid plan that provides benefits under a statutory hybrid benefit formula other than a lump sum-based benefit formula (such as a plan that provides for indexing as described in section 411(b)(5)(E))—a plan to which section 411(a)(13)(A) does not apply—ensure compliance with the minimum present value rules of section 417(e)?

The statutory hybrid plan described above would ensure compliance with the minimum present value rules of section 417(e) by selecting a reasonable forward-looking assumption for inflation (or other indexing basis, if any). The rate, or the basis for determining the rate, should be specified in the plan. The same standards would apply to the selection of this assumption as to any other assumption that is used to determine actuarial equivalence under the plan (other than the discount rates, which are specified under 417(e)). This assumption should not be tied to actual historical inflation over a short-term period, as this would not necessarily be indicative of expected future inflation. Reasonable options might include expected inflation implied by the spread between treasury inflation-protected securities (TIPS) and fixed-yield treasuries, actual average inflation over a relatively long period of time (e.g., five to 10 years), or a reasonable fixed rate.

6) *How does a statutory hybrid plan determine the section 417(e) minimum present value of the participant's benefit where a portion of the benefit is determined based partly on the benefit under a lump sum-based benefit formula, although that portion is not determined under a lump sum-based benefit formula?*

The Pension Committee does not offer a response at this time.

7) *Should the proposed alternative method of satisfying the conversion protection requirements that does not require a comparison of benefits at the annuity starting date be broadened to apply to forms of distribution other than a single-sum distribution? If this rule should be broadened, what rules would ensure that the benefit attributable to the opening hypothetical account balance is not less than the benefit available under the same generalized optional form under the pre-conversion formula (which may include subsidized early retirement benefits and other retirement-type subsidies) consistent with the goal of having a simplified alternative?*

We acknowledge and appreciate the introduction of a simplified approach to the single sum distribution following a conversion amendment. The question of how to broaden this simplified approach to other optional forms presents a number of technical difficulties. We do not believe that there is a guaranteed way to utilize the opening hypothetical account balance while maintaining the goal of simplicity.

For forms other than single sum distributions, the existing *A + B* approach does not seem to be overly complex. Utilizing the provisions prior to the conversion and the accrued benefit as of the conversion date to determine the "A" annuity and subsequently adding the annuity equivalent of the "B" hypothetical account balance is a modest complication in most cases.

We nonetheless consider the possibility of a further simplified approach desirable. But it would have to be in the context of an expectation that the benefit attributable to the opening hypothetical account balance will not be less than the benefit available under the pre-conversion formula, rather than a mathematical guarantee of such a result.

One possible method for achieving an expectation of a non-decreasing pre-conversion benefit would be to allow the plan to accumulate the opening account balance with actual interest credits through the date of benefit commencement (in accordance with the limitations on the interest crediting rate provided in Section 1.411(b)(5)-1(c)(3)(iii)(F) of the proposed regulations). At the date that benefits are paid, the accumulated opening account balance then would be converted to a normal retirement annuity by dividing by a conversion annuity factor at commencement age that is no greater than the factor determined using the assumptions utilized at the time of conversion. The use of current 417(e) rates, if more favorable, would be optional—not required. The annuity payable at a date earlier than normal retirement age then would be determined utilizing the early retirement factors applicable to benefits prior to the conversion.

This approach to forms other than single-sum distributions would eliminate the risk of a lower commencement benefit due to changes in conversion assumptions and early retirement subsidies. It would not eliminate, however, the risk of a decrease due to actual interest crediting rates being lower than implied by the assumptions at conversion. This risk, though, seems consistent with the possibility in the single-sum distribution option provided in the proposed regulations. A protection for the overall accrued benefit not decreasing, as provided in proposed regulation Section 1.411(b)(5)-1(c)(3)(iii)(C), would be warranted for this other-than-single-sum approach as well.

8) *How does a statutory hybrid plan that uses a variable interest crediting rate that may potentially be negative satisfy the fractional rule of section 411(b)(1)(C) if the 1331⁄3 percent rule of section 411(b)(1)(B) is not satisfied?*

The historical approach used to test backloading required that the 133 1/3 percent test be applied based on any theoretically possible interest credit rate. (The test, technically has been applied using the current interest credit rate, but in order to demonstrate that the plan passes "by design" the test must be repeated for any possible rate—effectively requiring that any variable rate be treated as being 0 percent indefinitely into the future.) This approach has forced many plans to implement minimum crediting rates to avoid a backloading violation. As this approach is not written into the statute, or even into the 411(b) regulations, we would like to call for alternatives that are more in line with reasonable future expectations. This alternative approach becomes increasingly important as we consider the possibility of using equity-based interest credit rates.

The backloading rules were established to ensure that a sponsor could not skew accruals in order to circumvent the vesting rules. The most important consideration, therefore, is that there be no reasonable expectation of backloading at the time that a benefit is accrued. The mere possibility that lower-than-expected interest credit rates possibly might serve to reduce the value of a past accrual relative to some future accrual should not be relevant to this analysis. It would be appropriate for the regulations to establish a reasonable minimum expected rate for each of the permissible interest crediting bases, which is consistent with long-term expectations for that rate. These rates could be fixed or they could be tied to current market yields. A standard that ties to market yields, however, should provide some lead time before plan design changes are required. For example, if the expected value of a particular interest credit rate is reduced due to a drop in market yields, causing a pay credit schedule that previously satisfied the backloading analysis to fail, the sponsor should have a reasonable period of time (e.g., two years) to make a prospective adjustment to pay credits (most likely a reduction in pay credits for older participants, although an increase for younger participants also might be considered). During that time, a subsequent rise in yields could make the adjustment to pay credits unnecessary. As an alternative, a single fixed long-term rate, such as 3 percent, could be used for all bases—disregarding the risk premium included in longer bond yields and equity returns. Disregarding the risk premium is "conservative", in that it would permit less backloading than otherwise might be supported by the reasonable expectations described above. Anything more stringent goes well beyond the intent of the backloading rules and puts cash balance plans at an unreasonable disadvantage relative to DC plans.

Another alternative would be to allow the use of any cumulative minimum annual interest credit in testing backloading. Such an approach would not guarantee against backloading under the strictest historical interpretation, but it is another safeguard against backloading under reasonable expectations.

Fractional Rule

It is theoretically possible to test a cash balance plan for backloading using the fractional rule, but difficult to ensure that a plan passes by design. Revenue Ruling 2008-7 provides an example of how this test would be applied for a single year for one plan. Under this approach, future pay credits are based on 10-year average compensation, while future interest credits assume that the current credit remains in effect for all future years. The current benefit must be no less than the projected benefit at normal retirement multiplied by current service over projected service at normal retirement. In contrast to the 133 1/3 percent rule, a lower interest credit rate makes it easier to pass rather than more difficult to pass. As a result, the fact that the interest crediting rate potentially might be negative should not cause any concerns about a plan's ability to pass this test. As discussed above, it might be appropriate to apply a reasonable minimum credit rate in any such analysis—instead of allowing a negative rate to be used since such a rate would be more in line with expectations.

The regulations require that all relevant factors be kept constant. An argument can be made, however, that for purposes of this test, the factor that should be kept constant is the current reasonable expectation for future credits, rather than a single year's crediting rate.

In general, this type of year-specific analysis of backloading under the fraction rule will be of limited usefulness since it cannot be used to show that a plan passes by design. It might be more practical if a plan could adopt a fractional rule minimum benefit as a failsafe mechanism. We would welcome such a failsafe design approach—as long as the fractional rule testing could be done using a pre-defined reasonable assumption for the future interest credit rate.

9) *For purposes of the plan termination rules, should a floor, ceiling, or reduction that applied to an equity-based rate in an interest crediting period be treated as applying in the same manner to the third segment rate or is it appropriate for such an adjustment to be disregarded or otherwise modified for purposes of such rules?*

We believe that a floor or ceiling applied to an equity-based rate in an interest-crediting period should be treated as applying in the same manner to the third segment rate. If the ceiling rate is a variable rate, however, that rate would have to be converted to a fixed rate before the limit could be imposed. The conversion to a fixed rate would follow the same rules that would apply on plan termination as if that ceiling rate had been the plan's actual interest credit rate.

10) *Under the relief to be provided pursuant to § 1.411(d)–4, A–2(b)(2)(i), which authorizes amendments that reduce a section 411(d)(6) protected benefit only to the extent necessary to satisfy the requirements of section 411(b)(5), should a statutory hybrid plan with an interest crediting rate that is impermissible under the final market rate of return rules be permitted to be amended to change the future interest crediting rate with respect to benefits that have already accrued to any permissible rate using the maximum permitted margin for that rate or should that be dependent upon the reasons that the pre-amendment rate exceeded a market rate of return? Thus, for example, should a plan with an impermissible bond-based rate (without a fixed component) be permitted to switch to any permissible rate, bondbased or otherwise, using the maximum permitted margin for that rate? Should a plan with an impermissibly high standalone fixed rate be permitted to switch to the maximum rate of any type, should it be permitted to switch to the maximum permitted bond-based rate with the maximum permitted floor for that rate (the third segment rate with a fixed 4 percent floor), or must it switch to the maximum permitted standalone fixed rate (a fixed rate of 5 percent)? Should a plan with a permissible bondbased rate but with an impermissibly high fixed floor be permitted to switch to the maximum rate of any type, should it be permitted to retain the preamendment bond-based rate while reducing the floor to the maximum permitted floor for that rate (a fixed 4 percent floor), should it be permitted to switch to the maximum permitted standalone fixed rate (a fixed rate of 5 percent), or must it switch to the maximum permitted bond-based rate with the maximum permitted floor for that rate (the third segment rate with a fixed 4 percent floor)?*

Sponsors should receive Section 411(d)(6) relief for rate changes required for compliance under Section 411(b)(5) with sufficient flexibility to permit plan sponsors to best maintain their current plan design objectives (as reflected by their existing interest crediting rates) while achieving compliance with the proposed regulations.

The desire for flexibility for sponsors who currently exceed the proposed maximum market rates of return needs to be balanced with the inequity of giving those sponsors additional choice in interest credits while limiting sponsors who already have a permissible rate from making any changes. For example, it would seem inappropriate to allow a plan sponsor with a 5.5 percent fixed rate to elect any of the available safe harbor interest rates while forcing a sponsor with a 5.0 percent fixed rate to keep that rate intact.

As to the specific examples provided in the preamble to the proposed regulations, we believe the following options would be reasonable:

- Impermissible bond-based rate (without a fixed component): We believe it would be reasonable to allow a sponsor to elect from amongst any of the permissible bond-based rates using the maximum permissible margin.
- Impermissibly high stand-alone fixed rate: It would seem reasonable to constrain a sponsor who currently is using an impermissibly high fixed rate to use the maximum fixed rate of 5 percent.
- Permissible bond rate with impermissibly high fixed floor: It would seem reasonable to allow this sponsor to elect either to: (1) reduce the fixed floor to the maximum permitted under the proposed regulations or (2) eliminate the bond-based rate and move to the maximum permitted fixed rate. It does not seem equitable to make a plan that is currently crediting some type of short-term bond rate with a 4.5 percent floor to move to the third segment rate (a basis that is significantly different and, in past history, nearly always above 4.5 percent).

The above examples, however, only address some of the many variations that exist in the marketplace. Additional rules are required to cover situations that do not neatly fall into combinations of a fixed-rate and a bond-based variable index. For example, a plan that currently utilizes the greater of two variable indices would require relief to eliminate one of those indices.

It would not be possible to cover all of the likely situations in this response (or likely in the final regulations). A programmatic approach to defining the "extent necessary" instead might be warranted. For example, the following might be a systematic approach that could be broadly applied:

> (A) A plan sponsor first may take action to eliminate multiple "variable rates" to arrive at a single variable interest crediting rate. Consideration might be given to limiting the elimination of the variable rate to the one with the lower compound return over the past five or ten years. Any "reduction" applied to the index or fixed ceiling on the index should be retained and considered as a part of any "cumulative return evaluation."
> (B) If the retained variable rate from step (A) is permissible under the proposed regulations, then no further changes could be made to that rate. If the variable rate is not permissible, a sponsor would be able to elect from among the permissible alternatives, using a reasonable classification of the existing rate (bond-based, plan-asset-based, insurance-contract-based or RIC-based).
> (C) To the extent that the stand-alone permissible rate developed from (B) is still impermissibly high when combined with any applicable fixed rate floors, the sponsor should have the flexibility either to (1) eliminate the variable rate and adopt the 5 percent maximum fixed rate or (2) reduce

the fixed rate floor to permissible levels (whether the 4 percent annual bond-rate floor or the 3 percent cumulative floor applicable to any permissible crediting rate).

The Pension Committee appreciates the opportunity to provide input to the IRS on these important regulations. We would be happy to discuss any of these items with you at your convenience. Please contact Jessica M. Thomas, the Academy's pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely,

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