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December 18, 2014

CC:PA:LPD:PR (REG–111839-13)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Final and Proposed Hybrid Retirement Plan Regulations Published in September 2014

To Whom It May Concern:

The American Academy of Actuaries[1] Pension Committee respectfully requests your consideration of its comments regarding the updated final and newly proposed regulations for hybrid retirement plans (REG–132554–08 and REG-111839-13). The Committee appreciates the opportunity to comment on the proposed regulations as well as the remaining relevant questions posed to respondents.

The Committee commends the IRS for the generally reasonable approaches and additional clarity provided by these regulations. We believe that hybrid plan sponsors will favorably view these regulations and will look forward to the finalization of the newly proposed regulations. Together these regulations should eliminate much of the uncertainty plan sponsors have experienced during their sponsorship of hybrid plans. Further, we hope that this clarity will encourage the creation of new hybrid plans.

Final Regulations: Additional Rules Regarding Hybrid Retirement Plans

We are pleased with the additional flexibility provided in certain areas of these final regulations—in particular the confirmation of a plan sponsor's ability to provide subsidized forms of benefit, the relaxation of the cap on maximum interest rate floors to be used with the Notice 96-8 rates and the higher permissible fixed interest crediting rate. These changes represent improvements to the market rate standard and will avoid interest-crediting-rate reductions that would have been unpalatable to plan sponsors and detrimental to participants.

We would appreciate your further consideration of our comments on the following areas of the final regulations where we believe additional clarification could result in easier or more consistent plan

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and U.S. actuarial profession. The Academy assists public policymakers on all levels 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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administration and, in some cases, afford sponsors the opportunity to design plans that would be desirable both to the employees who benefit from them and the companies that sponsor them.

Lack of Availability of Indices for Use in Interest Crediting
The Committee appreciates that the IRS reserves the right to add additional interest crediting rates through the use of the Internal Revenue Bulletin. We believe that the IRS should use this authority to permit a plan to use a published broad index or a combination of such indices. Acknowledging that there are a wide variety of published indices not all of which will satisfy the broadly diversified / volatility criteria, it would seem reasonable that the allowable indices could be limited in the same way that a regulated investment company ("RIC") selection is limited.

This additional flexibility would permit a sponsor to select a well-established index such as the S&P 500 Index, Dow Jones Industrial Average or Barclay's Aggregate Bond Index. While the majority of these indices are tracked by Exchange Traded Funds and/or Indexed Mutual Funds that attempt to mimic their returns, selecting such an RIC subjects participants to an unnecessary risk of the administrator of those funds making administrative errors or failing to adhere to the mandate to track the index. If the IRS would provide a list of acceptable indices—which might include, for example, RICs tracking indices that would satisfy the volatility / diversification rules—sponsors could provide the desired index-linked returns without exposure to manager and other risks by referencing the return on that index and specifying the source of those returns (e.g., the Wall Street Journal, Bloomberg, or other generally accepted source) to avoid any ambiguity as to the appropriate credit.

Specification of Some Combination of Investment-based Rate of Return with Annual Floor Satisfying the Market Rate of Return Rules

Regulations Section 1.411(b)(5)-1(d)(1)(viii)(B) permits the Commissioner to provide for additional interest crediting rates that are combinations of rates, including an annual minimum in conjunction with the "Other Rates of Return" in §1.411(b)(5)-1(d)(5). While we agree that it would be impractical for the IRS to opine on an infinite number of different combinations of fixed returns and RICs, we believe many plan sponsors would find it highly appealing to offer a plan design that could provide for a somewhat reduced investment return upside in exchange for a more stable downside. Thus, while providing a limitless combination of rates is arguably infeasible, we would nonetheless encourage the IRS to consider addressing a combination of annual minimums with some well-known RICs such as an S&P 500 Index Fund.

A design that provides somewhat reduced upside investment returns in exchange for downside protection would have a significant appeal to participants, especially those older participants nearing retirement. For instance, an annual floor could be combined with either a percentage of the investment returns or an annual maximum interest crediting rate. Because of the inability to diversify or be provided with an annual floor, a near-retirement participant would likely experience higher volatility in an equity-linked statutory hybrid plan than a DC portfolio with self-directed investment. As a result, following a market downturn, except in the rare case that a plan offers variable annuity options, participants may feel compelled to take a lump sum in order to retain the market exposure necessary to potentially recover from the downturn. A design crediting a return as described in the table above might provide participants with a higher expected return but limited downside risk. This may promote a higher annuity take rate by participants, which provides them with critically necessary longevity protection.

Granting approval of such a design might also provide a workable solution to the questions asked in the proposed regulations for plans that currently provide an annual floor with an investment-based (or other "paragraph (d)") interest crediting rate. We will discuss that further in conjunction with our comments on the proposed regulations.

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In addition to addressing workable combinations of annual minimums with some well-known RICs, statutory hybrid plan sponsors and their participants would benefit from a well-defined approval process for other RIC / annual floor combinations. Sponsors seeking to provide an account balance plan that best suits the needs of their participants may very well determine that the optimal interest crediting rate might not be provided in one of the generic examples and would, therefore, need the ability to seek approval for their proposed design.

Requests to Introduce 'Self-Directed Investment' into Statutory Hybrid Plans
Another possible solution to the late-career diversification problem in an equity-linked hybrid plan is to further explore possibilities associated with participant "self-direction." The Committee appreciates the challenges that the introduction of self-directed interest crediting rates into the defined benefit environment would pose to regulators, sponsors and participants. We appreciate the clear offer of likely anti-cutback relief for sponsors who already had such designs in place on the issuance date of the final regulations.

Nonetheless, the Committee believes that developing a workable solution to those challenges is in the interest of defined benefit plan participants. Allowing interest crediting based upon reasonably volatile investments—as the final regulations do—without an opportunity for participants to elect a less volatile option will pose a challenge for older participants and generally risk-averse participants of any age. The opportunity for self-direction would allow participants to reduce (or increase) the level of risk as they deem appropriate. The challenges described in the final regulations appear to be technical in nature rather than opposition in principle to allowing participants to make choices. Thus, we encourage the IRS to consider further study of this opportunity and invite legislators to consider any options that might alleviate the technical concerns.

The Committee knows that a number of plans exist that permit participant self-direction. It is likely that some investment options offered under those plans may provide returns that don't meet the market rate of return requirements of the regulations. If the IRS intends to provide additional guidance on self-directed statutory hybrid plans, we request that the effective date of these final regulations be delayed for those sponsors to avoid two redesign cycles—first to comply with these regulations and second to adapt to any changes in self-directed investment guidance.

Clarity on Plan Termination Rules for Plans with Interest Crediting Rates in Excess of Market Rate of Return

As described in §1.411(b)(5)-1(e)(2)(ii)(A), the interest rate used to roll forward an account balance to future annuity starting dates following a plan termination is equal to the five-year historical average of the plan's interest crediting rates. We believe it would be beneficial to receive guidance on how to incorporate historical rates that do not meet the market rate rules in the final regulations but represented a reasonable interpretation of the statute.

As an example, a plan that was providing an interest crediting rate of the greater of 5.5% and the 30-year Treasury would have been providing an interest credit of 5.5% for the past five years. If the plan were terminated, the most recent five-year average without adjustment would equal 5.5%, which is a going forward rate that would be non-compliant under the final regulations. Alternatively, the rates used in the five-year period could be adjusted to bring them into compliance with the final regulations before averaging, resulting in a going forward interest credit of 5% or 6% (depending on the compliance option chosen by the sponsor).

We understand that the view of the IRS/Treasury is that past rates should not be adjusted as long as they represent reasonable interpretations of the statute. We would appreciate formal documentation

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of the IRS/Treasury position on this issue. Furthermore, we believe that additional guidance would be helpful for plans that provide interest credits on distributions that fall between the general interest crediting dates (e.g., a plan that provides interest credits on the last day of the year but also credits interest through the distribution date for payments made before year-end).

Usefulness / Complication of the Subset of Assets Method

The IRS responded favorably to requests for additional flexibility in interest crediting rates by introducing the "subset of plan assets" method under §1.411(b)(5)-1(d)(5)(ii)(B). The complicated restrictions, in particular the requirement that the assets approximate the liability for those benefits, may compromise the provision's usefulness.

While it is not clear to us why such a restriction is necessary, at a minimum we believe additional guidance is needed to provide sponsors with comfort sufficient to implement such a design. We believe that clarification is needed regarding the consequences of having assets that fail to be approximately equal to the liabilities:

- What rules / restrictions exist for reallocating assets from another subset of assets to the one used to establish the interest crediting rate ("backing subset") such as limitations on how those assets must be allocated?
- Are plan assets required to be allocated to the backing subset first in order to achieve the approximately equal standard?
- What would happen if asset performance was such that the plan's entire asset pool was insufficient to satisfy the liability associated with the interest crediting rate? Would the plan then be permitted to elect to move to interest crediting based on the full value of assets or, if a sponsor wanted to continue to use the subset of assets method, would the plan have relief from the requirement to have assets approximately equal liabilities during the period the plan's entire assets were below the applicable liabilities?
- What timeframe following a substantial asset decline would be permitted before the assets were replenished if the sponsor wished to continue to use the subset of assets method?

How would the minimum funding rules treat these plans' obligations? Suppose the subset of plan assets was invested in an S&P 500 RIC. Would the actuary be required to project the balances forward at an expected return and then discount back at the appropriate segment rates / yield curve rate? Or, alternatively, would the actuary be able to assume the funding target equals the current account balance (modified, as appropriate, to reflect the value of embedded options such as the preservation of capital minimum or other minimum interest crediting rate), as the only source for higher balances would be higher achieved asset returns?

Approval Process for 'Comparable' RICs

Plan sponsors who have elected to use a RIC-based interest crediting rate that subsequently ceases to exist are required to select a RIC that has reasonably similar characteristics under §1.411(b)(5)-1(e)(3)(v). In some cases, a given RIC may be well defined by referencing an index or broad class of assets. For those situations, a plan sponsor will likely find it easy to select an alternate RIC to succeed as the basis for the interest crediting rate. However, in other cases, the RIC may be an actively managed fund that is not easily replicated. In those circumstances, plan sponsors will need additional guidance, safe harbors or an approval process from the IRS for the change in the basis – especially given the lack of detailed guidance on the factors to consider in determining comparability.

Furthermore, we believe that the regulations should permit changes to RICs in situations other than when a RIC ceases to exist. An investment-based return credited to an account balance should, in theory, be able to be managed by the plan sponsor in the same way as a defined contribution

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allocation option. As such, a sponsor may reasonably conclude that an existing RIC is no longer the most appropriate basis for an interest crediting rate for a variety of reasons including manager performance, style drift, or other common investment manager evaluation criteria.

In situations where the sponsor is choosing to change the nature of the RIC for reasons other than performance or style drift, we believe that §411(d)(6) protection of the old basis under current rules is appropriate. There may be other situations (such as consistent performance issues relative to peers or benchmarks) where a change should be made in the interest of participants, but §411(d)(6) protection would serve as a barrier to making such a change: it would present a one-sided risk to the sponsor and create the substantial administrative burden of maintaining two accounts. We believe that the regulations should provide for a change with anti-cutback relief in such situations. At a minimum, there should be a process by which the sponsor can request approval for a change without providing cutback protection. Such an approach would be in the best interest of participants.

Lack of Clarity on Fixed Conversion Factors
Under the final regulations in §1.411(a)(13)-1(d)(3)(i), a plan is not considered to have a lump sum-based formula ("LSBF") unless the accrued benefit determined under the LSBF is actuarially equivalent to either the normal retirement benefit or the immediately commencing benefit, using reasonable assumptions. We believe that this definition is preferable to that previously provided as it enables a LSBF design to provide for early retirement subsidies where such an approach would have previously been difficult.

Notwithstanding the positive change, we want to point out that this definition could be problematic for plans using the reasonable and not uncommon approach of applying a fixed factor to convert from the account balance to an annuity. While such a fixed factor might meet the actuarial equivalence criteria currently, there would clearly be a risk that as economic and mortality circumstances change, the factor would no longer meet this criteria. A design involving an account balance and a fixed conversion is simple and easy for participants to understand. If enabling such design for the future (and avoiding changes to existing plans with such provisions) is of interest, some type of "evaluate and forget" approach would be needed to allow for a fixed factor that is deemed actuarially equivalent at the date of implementation and appropriately adjusted from time to time to remain current. Alternatively, regulations could grant explicit permission for periodic updating for fixed factors— perhaps with a specified update period (with anti-cutback relief) to the extent the prior conversion factors no longer meet the actuarial equivalence criteria.

Above all, we believe that clarity is needed as to what a reasonable set of actuarial assumptions might be and whether reasonableness would be evaluated on an ongoing basis with respect to assumptions such as interest rates that exhibit significant variability. Given that many plan sponsors designed plans with fixed factors intending to have them operate as LSBFs, we suggest that the IRS provide a one-time opportunity for plan sponsors to eliminate the fixed factor with anti-cutback relief.

Proposed Regulations: Transitional Amendments to Satisfy the Market Rate of Return Rules for Hybrid Retirement Plans

Responses to Specific Questions
In the proposed regulations, four specific questions were asked related to a plan that uses a composite interest rate that is an investment-based rate of return with an impermissible annual minimum rate.

1. *Should the required amendment eliminate the minimum rate (and eliminate any reduction to the investment-based rate of return), so that the required rate after amendment is the unreduced investment-based rate of return?*

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We believe that sponsors should be given a choice with respect to the remedy for modifying rates to bring them into compliance with the final regulations. Eliminating the fixed minimum rate and eliminating the percentage reduction is one possible remedy that should be permitted, but we do not believe it should be the only option.

2. *Should the required amendment change the interest crediting rate to another permitted rate that is less volatile than the unreduced investment-based rate (such as a rate described in §1.411(b)(5)-1(d)(3)) with a fixed minimum rate of 4 percent per year?*

   Again, we believe this should be one of the choices made available to plan sponsors in complying with the newly issued regulations.

3. *Should the required amendment depend upon the level of the minimum rate and the extent of any reduction to the investment-based rate of return?*

   We acknowledge the challenge of setting a rule with the infinite combinations of minimum rates and reductions that are possible. As discussed above in our response to the first question, we do believe that choice should be made available to sponsors, but also that effort should be made to limit the amount of benefit reduction in the case of these combination rates that likely will require variations depending upon the current level of minimum rates and reductions.

4. *Should the plan sponsor have a choice among alternative required amendments to bring the plan into compliance?*

   Yes. We think that, given that plans of this nature already in existence were largely designed without clear guidance as to what would be permitted, allowing for selection among a limited set of alternative remedies would be fair.

Other Comments
In the interest of simplicity and flexibility, we believe that applying a condition of "not more than the third segment rate" should be an acceptable way of remedying any of the above violations for market-based returns combined with annual floors.

The proposed regulations clearly state that to remedy a plan that is using the greatest of two or more variable bond-based rates the plan must be amended to use the lesser of that combination rate and the third segment rate. We further suggest an expansion of this rule to apply to a plan that is currently crediting the lesser of two impermissibly high rates of return.

Furthermore, as we suggested with respect to the final regulations, we believe that allowing interest crediting rates that combine annual floors with reductions / ceilings applied to well-known, investment-based RICs could provide a useful plan design and permit the use of an interest credit that is not expected to exceed a market rate of return. We recommend that the final version of the proposed regulations include some approved combinations and a process for approval of other combinations.

Many plans that are currently not in compliance could be offered a choice between the two alternatives described in our answers to the specific IRS questions and a third alternative to adopt the approved RIC percentage for the most comparable approved RIC and the nearest annual minimum floor. For example, a plan that uses a RIC based on a broad U.S. stock market index that is currently providing an annual floor of 0% could elect to:

- Eliminate the annual floor of 0%,

- Change to using the third segment rate but not less than 4%, or
- Elect to use the pre-developed IRS guideline of an annual floor of 0% in combination with 71.53% of the total return on the S&P 500 Index Fund (in our simplified example)

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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 Matthew Mulling, the Academy's pension policy analyst (202-223-8196; mulling@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely,

Michael F. Pollack, MAAA, FSA, FCA, EA
Chairperson, Pension Committee
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