

Plan Design After PPA Session 72, October 16, 2007

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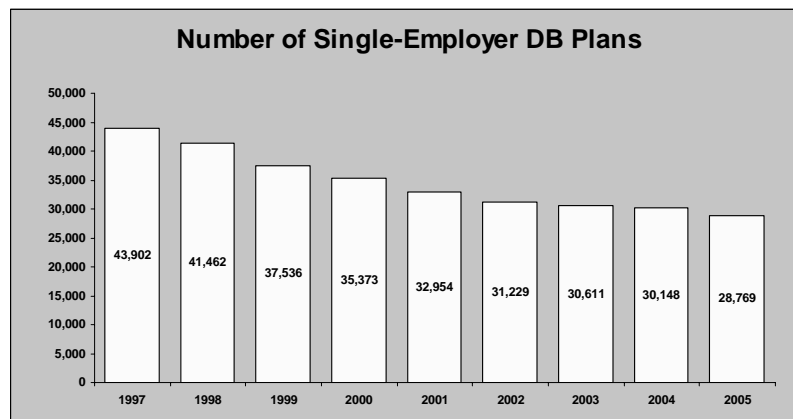
Agenda

- DC Plans After PPA
 - What is different and what are the trends?
- DB Plans After PPA
 - What is different, and what happens now?

Key DC Plan Issues and PPA '06 Themes

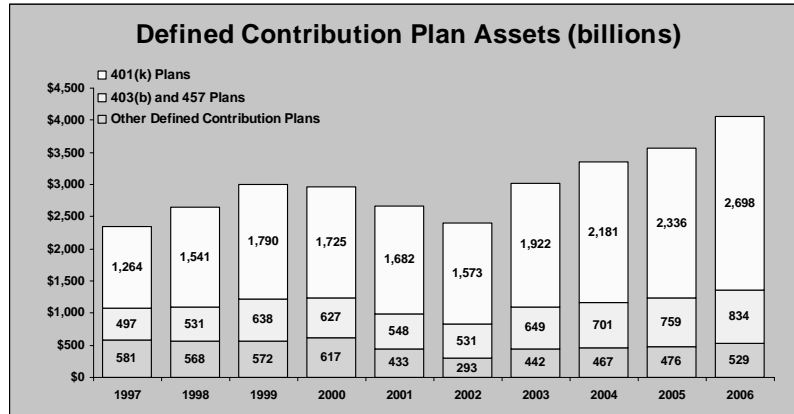
- Change to employee self-reliance culture
- Lack of employee savings
- Asset allocation and diversification
- Fee reasonableness and disclosure

Defined Benefit Plans Are Declining



Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2005*

\$4.1 Trillion in DC Assets



Investment Company Institute, 2007 *ICI Fact Book*

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Safe Harbor, Default Investments and PPA '06

- Pension Protection Act created Safe Harbor Automatic Enrollment Plans...and the need for suitable default investment
 - PPA '06 Safe Harbor requires prescribed employer contribution, 100% vesting after 2 years, automatic enrollment of all current participants without a deferral election and automatic annual deferral increases
 - Congress directed DOL to issue regulations on suitable default investment
 - Condition of ERISA Section 404(c) protection for Safe Harbor Automatic Enrollment Plans

Default Investments and PPA '06

- DOL issued a proposed regulation in September 2006 establishing Qualified Default Investment Alternatives (QDIA)
 - Regulation applies to all individual account plans
- QDIA's include
 - Age or retirement date based allocation funds
 - Balanced funds
 - Managed investment accounts

Default Investments and PPA '06 (con't.)

- Implementing QDIA
 - Participant had opportunity to direct investment, but didn't
 - Notice must be provided to participants at least 30 days before
 - QDIA becomes a QDIA
 - Each subsequent plan year
 - Plan must provide that any material received by the plan on QDIA will be provided to participants invested in QDIA

Default Investments and PPA '06 (con't.)

- Implementing a QDIA (cont'd)
 - Participant has opportunity to move out of QDIA on same frequency as other investments—at least quarterly—and without financial penalty
 - Caution: What is the impact of trading restrictions?
 - Plan must provide a broad range of investment alternatives, as described in ERISA section 404(c)
 - Changes are being considered to the proposed default investment regulation
 - Some industries disappointed at being left out, primarily relating to the exclusion of stable value and fixed interest alternatives

What To Do With “Bad” Investments

- Fiduciaries have feared taking on more liability by making the move from one investment to another
- Fiduciaries did not want to lose ERISA 404(c) protection by making affirmative investment election on behalf of participants
- Congress, in the Pension Protection Act, endorsed the notion that it is better to replace “bad” funds rather than freezing them

PPA '06 Fund Mapping

- Qualified Change in Investment Options
 - New investment must have risk and return characteristics similar to those of the terminating investment
 - Notice must be provided to participant 30 to 60 days before investment change
 - Describing change and giving participant opportunity to change and avoid mapping

Investment Advice Changes

- PPA makes it possible for plan service vendors to deliver investment advice to participants
 - Changed the prohibited transaction rules
 - Plan fiduciaries must evaluate investment advice provider and be confident in the provider's capabilities
 - Plan fiduciaries must also evaluate advice providers on an ongoing basis

PPA '06 Advice Requirements

- Plan fiduciary must authorize the advice fiduciary to work with the plan
- Advice fiduciary must acknowledge in writing that it is a fiduciary on advice
- Investments must *either be*
 - Revenue-neutral to the provider, or
 - Through computer model approved annually by independent party
- Information on advice service, including fees, must be provided to participants before any advice is given and annually thereafter

PPA '06 Advice Requirements (con't.)

- Participants must direct that advice be implemented—no automatic implementation
- Advice fiduciary's compensation must be reasonable
- Plan fiduciaries must have an annual independent audit of program with written report of findings
- This may be useful for fiduciaries and participants—fiduciaries must keep a close watch on details

Post-PPA Trend 1: Auto-Pilot Plan Provisions

- Automatic Enrollment
 - 26% offer and 18% plan to offer in the next 12 months¹
 - Roughly 90% of participants stay in the plan and the opt-out percentage varies little based upon the default rate
 - % of auto-enrollment sponsors using other provisions:
 - Automatic Deferral Increase – 18%
 - Target-date Default Investment – 50%
 - “Full Auto-Pilot” – 25% to 40%
 - New Safe Harbor (PPA ‘06)

¹Aon Consulting's 2007 Benefits and Talent Survey
Other statistics compiled using survey data from Fidelity, T. Rowe Price and Vanguard

Post-PPA Trend 2: Target-Date (Lifecycle) Funds

- Steady increase in use of target-date funds in DC plans (from \$11 billion in 2002 to \$78 billion in 2006)¹
- Over 30 mutual fund companies offer them
- PPA ‘06 Qualified Default Investment Alternatives
- Typically, a better option than managed accounts
- Portfolios are becoming more aggressive in years nearing retirement
- Possibly pursue target-date portfolios, instead of pre-packaged mutual funds

¹Investment Company Institute, 2007 ICI Fact Book

Post-PPA Trend 3: 401(k) Fees In The Spotlight

- 9/06 – Wave of lawsuits begins
- 11/06 – US Government Accountability Office Report
- 3/07 – House Education & Labor Committee Hearings
- 4/07 – SEC Chairman’s Speech and Department of Labor Request for Information
- 7/07 – 401(k) Fair Disclosure for Retirement Security Act of 2007 bill proposed by U.S. Rep. George Miller

- Key Themes:
 - Unreasonable fees and revenue sharing
 - Lack of monitoring by plan sponsors
 - Insufficient disclosure to participants

Expense Framework – Scenario #1

Plan Fees	Vendor Expenses	Fee Usage
Transaction Charges	Transactions	Transactions
Per Head Charges	Plan Administration	Profit
Sub TA Fees		Administration Cost
12b-1 Fees		
Other Asset Based Charges		
Investment Management Fees	Investment Management	Investment Cost

Expense Framework – Scenario #2

Plan Fees	Vendor Expenses	Fee Usage
Transaction Charges	Transactions	Transactions
Per Head Charges	Plan Administration	Excess Revenue
Sub TA Fees		Profit
12b-1 Fees		Administration Cost
Other Asset Based Charges		Investment Cost
Investment Management Fees	Investment Management	

DC Plan Fee Analysis

- Fee litigation underscores importance of fiduciaries having a thorough and up-to-date understanding of expenses paid from plans
- Understand the “Expense Framework” as it relates to your plan
- Adjust where appropriate
 - Lower/eliminate direct-billed charges
 - Purchase additional services
 - Use lower-priced investment share classes
 - Lower/eliminate “other” soft dollar charges

DC Plan Fee Analysis (con't.)

- On an ongoing basis
 - Develop policy to monitor fees
 - Require revenue sharing disclosure from vendor
 - Review fees and expenses periodically and document
- Consider “gross pricing” approach
 - Lowest possible investment expense (minimal or no revenue sharing), possibly using collective trust or separate account products
 - Vendor provides hard-dollar fee quote
 - Fees billed to plan sponsor, deducted from participant accounts and disclosed, or both

DC Trend Synopsis

- Through PPA '06 and subsequent congressional action, the government is openly supporting the concept that workers will need to be more self-reliant to achieve retirement savings goals
- DC savings rates, investment risk and fee exposure must be addressed
- DC plans need to be properly structured to provide an adequate retirement for participants

DB Plan Design After PPA

Overall Trends

- “Traditional” Plans will continue to be frozen, move from a DB-centric to a DC-centric world
 - Potential for heavily unionized plans to join management plans and see more freezes
- Future DB plan redesign will focus largely on hybrid plans
 - Traditional plans will be amended to some extent, but latent interest in hybrids will result in growth
- DB characteristics will be found in more DC plans

DB Plan Design After PPA

- Myriad of issues need to be addressed before Hybrids can be redesigned:
 - Hybrid Plan Litigation
 - Pension Protection Act
 - Determination Letters
 - Technical Corrections Legislation
- Only then can plan design be considered
- Every plan needs to consider funding implications

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- Amendment consideration must now reflect its impact on a Plan's funded status.
 - To the extent an amendment lowers the funded status*:

<u>Funded Status After Amendment</u>	<u>Restrictions</u>
– > 100%	None
– 80% to 99.9%	None
–60% to 79.9%	Lump Sum restrictions apply.
	Enhanced funding requirements.
– < 60%	No benefit accruals allowed. No lump sums allowed.

* Special rules apply to bargained-for plans.

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Hybrid Plan Litigation

- Important because legal concerns virtually stopped plan design changes
 - Hybrid plans, especially cash balance, under increased attack from class action claims
 - Primary Grounds for Attack
 - Age discrimination
 - Whipsaw
 - Backloading
 - Participant communication
- PPA addresses litigation (prospectively)

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Hybrid Plan Litigation - Age Discrimination

- Statutory rule – rate of benefit accrual cannot decrease on account of age - Code § 411(b)(1)(H); ERISA § 204(b)(1)(H)
- Theory – because interest credits are “frontloaded,” growth in normal retirement age annuity slows as participants age

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Hybrid Plan Litigation - Age Discrimination

- Most common claim in hybrid plan cases
 - Easy to frame issue
 - Theory applies to virtually every cash balance plan, regardless of specific plan formula
- IBM decision
 - District court ruled cash balance plans are discriminatory
 - Seventh Circuit reversed initial IBM decision and found no age discrimination
 - Supreme Court denied cert

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Hybrid Plan Litigation – Age Discrimination

- Third Circuit (PNC case), Sixth Circuit (Rand McNally), and Seventh Circuit (IBM) have all since ruled that cash balance formulae are not, by their design, age discriminatory
- Issue on appeal in the Second Circuit, district court have found no discrimination
- PPA “fixes” issue, at least prospectively
 - Pre-PPA plans still at risk for periods before 6/29/05
- How does it work?

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Plan Design Issues – Age Discrimination

- Pre PPA Age Discrimination Concerns
 - Reducing benefit accruals on account of age

Example

Age	\$Pay Credit	Accumulated to Age 65 at 5%	Addition to Accrued Benefit Payable at 65 ($\ddot{a}_{65}^{(12)}=10$)
25	\$1,000	\$7,040	\$704
35	\$1,000	\$4,322	\$432
45	\$1,000	\$2,653	\$265
55	\$1,000	\$1,629	\$163
64	\$1,000	\$1,050	\$105

- Other plan design features that affect older employees more than the younger employees, such as wear-away (ADEA)
- How to handle early retirement subsidies (e.g. transition credits in cash balance plan)

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Plan Design Issues – Age Discrimination

- Post 6/29/05 Conversions, if plan is a “Statutory Hybrid Plan” that meet new PPA plan design rules, not age discriminatory
- Plan design requirements
 - Have level or increasing pay credit percentages as age increases (subject to backloading test, discussed later)
 - Design requirements will generally eliminate other age concerns e.g. Conversion amendment must meet minimum benefit rules (wear-away not permitted, discussed later)
 - 3-year vesting for benefits derived from employer contributions
 - Interest crediting rate must be no greater than “market rate” (discussed later)
 - Note, special interest crediting rules for terminating plans

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Pension Protection Act - Age Discrimination Standard

- PPA clearly provides for safe harbor from age discrimination suits
 - Accumulated Benefit Not Less Than For Younger, Similarly Situated Hypothetical Employee
 - Annuity Payable At NRA
 - Balance Of A Hypothetical Account
 - Current Value Of The Accumulated Percentage Of The Employee’s Final Average Pay
 - Effective For Periods Beginning On Or After June 29, 2005
 - No Inference For Prior Periods
- Net effect, so long as pay credits don’t decrease with age, you’re fine

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Hybrid Plan Litigation - Whipsaw

- Statutory rule – lump sum distribution must not be less than present value of normal retirement benefit, determined using 30-year Treasury interest rate and IRS prescribed mortality table – Code § 417(e)(3); ERISA § 205(g)(3)
- Theory – where plan’s cash balance crediting rate exceeds the 30-year Treasury rate, the “round trip” calculation will result in required lump sum payment that exceeds the cash balance account

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Hybrid Plan Litigation - Whipsaw

- Claim is plan specific – viable where plan provides interest credits that do not comply with IRS Notice 96-8
- Courts have fairly consistently ruled in favor of participants
- PPA “fixes” this issue for distributions after 8/17/06
 - Pre-PPA plans still at risk for prior distributions

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Hybrid Plan Litigation - Backloading

- Statutory rule – the accrual of normal retirement benefits must satisfy one of three permissible accrual rules – Code § 411(b)(1)(A)-(C); ERISA § 204(b)(1)(A)-(C)
- Various theories
 - A wear-away period following the implementation of the hybrid benefit formula will cause later accruals to result in backloading
 - Changes in variable interest rates can result in backloading
 - Where multiple benefit formulas exist in one plan, aggregation of the formulas will cause backloading

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Hybrid Plan Litigation - Backloading

- Backloading claims have not yet yielded dividends for plaintiffs
- Wear-away based claims dismissed in several cases, based on statutory rule that says plan amendments treated as in effect for all plan years – i.e., cash balance formula analyzed on its own, without consideration of interplay with prior, frozen traditional benefit formula
- Claim based on variable interest rate in cash balance plan recently dismissed in Boeing case
 - (“Greater of” backloading claim too)
- Possible issue for plans with multiple, ongoing benefit formulas
 - Especially with recent IRS statements regarding “greater of” formulae
- PPA did not change the backloading rules

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Hybrid Plan Litigation - Participant Communications

- Participants have alleged communication failures in two areas:
 - ERISA 204(h) requires advance written notice to participants of an amendment that significantly reduces the rate of future benefit accrual
 - Plan fiduciaries failed to provide an adequate summary plan description

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Hybrid Plan Litigation - Participant Communications

- 204(h) Notices – if notice requirement not met, plan amendment could be ruled ineffective
- In pending cases, issue is how much information is required under pre-2001 law, and was notice delivered properly
- Law changes 6/7/01 to require more specifics in the notice and added rule to Internal Revenue Code (§ 4980F)

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Hybrid Plan Litigation - Participant Communications

- SPD-based complaints include allegations that participants were not informed of details regarding wear-away
- Primary issues
 - How much detail is required in SPD
 - Is there a substantive remedy for an inadequate SPD
- PPA did not change 204(h)/SPD disclosure rules

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Hybrid Plan Litigation - Summary

- ERISA is now a very active area for class actions
- Scrutiny will continue for hybrid pension plans, and new theories of attack may develop
- PPA provides clear safe harbors and outlines of how to minimize, if not eliminate, plan design lawsuits

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Pension Protection Act - Market Rate of Return Addressed

- PPA now goes well beyond 96-8 in allowing plan sponsors to provide benefits appropriate for their staff
 - Variable Rates
 - Fixed rates
 - Variable Rates with Fixed Rate Floor
 - Capital Preservation
 - Transition Between Interest Crediting Rates

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Pension Protection Act – Minimum Conversion Rates

- PPA recognized that existing “Traditional DB” plans will want to convert to Hybrids
 - A+B Conversion Mandated
 - Wear-away Prohibited
- Some issues still remain
 - Other Methods Permitted as Add-on?
 - Early Retirement Subsidy
 - Payable Only from B Portion of Benefit?
 - Merger & Acquisitions

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Pension Protection Act – Other Hybrid Provisions

- Wipsaw Calculation Eliminated
 - Distributions after Date of Enactment, Regardless of When Benefit Accrued

- 3 Year Vesting
 - Effective Date is 1/1/08

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Hybrid Plans – Determination Letters

- Moratorium lifted
- Notice 2007-6 guidance on IRS review process
 - Age discrimination
 - Front-loaded interest credits are not age discriminatory
 - Will not rule on impact of prior conversion, including on whether wear-away could be age discriminatory
 - Lump sums must comply with Notice 96-8
 - Will review compliance with existing backloading rules
 - Post 6/29/05 conversions must comply with PPA
- Process is moving slowly

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Hybrid Plans – Determination Letters

- Apparent review process
 - Plans are being reviewed by a special group of agents who were recently trained on cash balance issues
 - Cash balance related issues are communicated to plan sponsor
 - After any identified issues are resolved, plans will be sent to original office for final resolution
- EGTRRA determination letter filings are required in the normal course, even if the prior application is still pending

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Technical Corrections

- Uncertain Prospects
- “Pure” Technical Corrections
- Congressional Staff Changes
- Congressional Priorities

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Plan Design Issues – Post PPA

Wear-away (Plan Conversions)

- Pre-PPA Typical Designs for Plan Conversions
 - “Hard freeze” with new hybrid formula applying to all years of service (wear-away possible); wide variety of methods/assumptions used to establish opening account balance
 - “Grandfathered” provisions, where prior plan continues for some number of years and hybrid formula applies to all years of service (“extended” wear-away possible)
 - “A plus B” approach, where prior formula is frozen and hybrid formula applies to future service only (no wear-away)
- For age discrimination reasons, PPA provides that post-6/29/05 conversions must:
 - Provide a minimum of the “A plus B” approach
 - Provide early retirement subsidy to “B” portion of benefit upon retirement

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Plan Design Issues

Wear-away (Plan Conversions)

- Plan design implications
 - Can provide “A plus B” either through amending existing plan or freezing existing plan and establishing new hybrid plan
 - Because “A plus B” is a minimum, other formulas can continue, but may be difficult to pass backloading requirements
 - Theoretically, can add floor benefit that is based on fractional rule....
 - Must design how to credit early retirement subsidy to “B”
 - Take early retirement subsidy from “A” and credit to “B”?
 - Compute degree of early retirement subsidy in “A” and also credit to “B”
 - Wait for regulations?
 - Application of 3-year vesting to “A”?

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Plan Design Issues

Backloading

- PPA is silent on this, so rules continue to apply
- General belief and preliminary IRS comments in determination letter process indicate that 133-1/3% test should be used for cash balance plans

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Plan Design Issues

Backloading

- Plan design
 - Plans with “pure” wear-away (“hard freeze” approach)
 - Some plaintiffs claim the year in which wear-away ends for an individual causes backloading (infinite increase)
 - IRS and court decisions on (Register v. PNC) indicate formulas should be tested separately
 - IRS position is that plans with two or more active formulas (e.g. prior plan and new plan formulas) should be tested as one plan formula, making it difficult to pass 133-1/3% test
 - “A plus B” minimum design will generally eliminate the multiple-formula wear-away issues as they pertain to backloading
 - Because interest crediting rate has bearing on passage of 133-1/3% test, issue as to rate to use when testing (no definitive guidance)
 - Low rate may necessitate “flattening” the pattern of pay credits

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Plan Design Issues

Lump Sum Payments (Whipsaw)

- Pre-PPA, a wide choice of interest crediting options, but Notice 96-8 proposed that lump sum would equal cash balance account if one of the listed indices, with associated margins, were used

<u>Index</u>	<u>Associated Margin</u>
3-mo. T-Bill	175 b.p.
6-mo. Or 12 mo. T-Bill	150 b.p.
1-yr. Treasury C.M.	100 b.p.
2-yr or 3-yr Treasury C.M.	50 b.p.
5-yr. or 7-yr. Treasury C.M.	25 b.p.
10-yr. or longer Treasury C.M.	0 b.p.
CPI	3 percent

- Rates plus margins are maximums
- If interest crediting rate in plan exceeds the maximums, must do whipsaw calculation

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Plan Design Issues

• Lump Sum Payments (Whipsaw)

- Post-PPA (years after 12/31/07) interest crediting rate cannot exceed “market rate of return” (future guidance needed)
- Safe harbor rates for plan design (Notice 2007-6, pending further guidance)
 - Notice 96-8 indices and margins (needed for moratorium plans for distributions prior to 8/18/06 for determination letter, or provide whipsaw)
 - Long-term investment grade corporate bond rate (minimum funding rate for years before 2008)
 - Third segment rate for funding (Sec. 430(h)(2)(C)(iii)), for years after 2007
 - 30-year Treasury rate
- Other plan design implications
 - Pre-retirement mortality issue (Berger v. Xerox) eliminated for plans that comply with PPA rules for interest crediting
 - Still a potential issue for other plans, or with respect to pre-compliant distributions from hybrid plans complying with PPA

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Plan Design Issues

- Lump Sum Payments (Whipsaw)
 - Other plan design implications
 - Employer can elect to have rates apply retroactively to period on or after 8/17/06
 - 411(d)(6) relaxed if amendment to retroactively change interest crediting rate is a cutback (may need 204(h) notice 30 days prior to retroactive effective date of amendment)
 - Amendment must be adopted on or before last day of first plan year beginning on or after 1/1/09
 - Can provide reasonable minimum interest crediting rate, if less than market rate of return
 - If interest crediting rate is less than 0 (e.g. if tied to an equity index), it cannot reduce account balance to less than sum of the pay credits at retirement

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Plan Design Issues

- Example 1: Starting a new cash balance plan today
 - 4% cash balance pay credits in all years
 - Interest credits: 30-year Treasury rates
 - 3-year vesting

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Plan Design Issues

- Example 2: Converting an Existing Traditional DB plan to Cash Balance today
 - Freeze current plan formula as of amendment date (“A”)
 - 4% cash balance pay credits in all years post-amendment (“B”)
 - Interest credits: 30-year Treasury rate or same market rate
 - 3-year vesting (A + B)
 - Provide 204(h) notice
 - Does prior plan have subsidized early retirement?

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Plan Design Issues

- Example 3: Amending a Pre-PPA Converted Hybrid Plan, that was Converted from Traditional to Hybrid after June 29, 2005
 - Objective: Obtain the protections offered under PPA
 - Retroactively amend plan to provide:
 - “A plus B” formula (benefit increases or neutral) as of original conversion amendment date
 - Market rate of return or safe harbor (potential to reduce benefits)
 - Make sure that “B” is not backloaded
 - 3-year vesting
 - Assess need for 204(h) notice

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Plan Design Issues

- Example 4: Amending a Pre-PPA Converted Hybrid Plan, that was Converted from Traditional to Hybrid Before June 29, 2005
 - Goal is to have a statutory Hybrid Plan
 - Changes needed will depend on IRS reaction to determination letter application
 - Possible plan design:
 - Retroactive amendment back to original conversion date to provide “A plus B” as of that date, with current accrued benefit as minimum benefit