AMERICAN ACADEMY of ACTUARIES

Internal Revenue Service
CC:PA:LPD:PR (REG-104946-07), Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

March 27, 2008

Re: Regulations on Hybrid Retirement Plans (REG-104946-07)

To Whom It May Concern:

On behalf of the American Academy of Actuaries[1] Pension Committee, I respectfully request your consideration of its comments regarding IRS Proposed Rules (REG-104946-07) on Changes Made by Pension Protection Act to Certain Hybrid Defined Benefit Retirement Plans. The proposed regulations provide much-needed guidance regarding the new rules in the Pension Protection Act of 2006 (PPA). We are providing comments on certain items of concern to the actuarial profession.

Transition to Hybrid Plan

Internal Revenue Code (IRC) Section 411(b)(5)(B)(iii) as amended by PPA provides that a plan must ensure that the benefit after a hybrid-conversion amendment is "not less than the sum of" the amounts described in subsections (I) and (II) ("A+B minimum"). This particular section of the Code provides an explicit minimum after conversion. However, the proposed Treasury regulations may be construed to attempt to reach beyond the statute's minimum and additionally force a no "wear-away" standard in proposed regulation 1.411(b)(5)-1(c)(4).

Consider the case of a plan sponsor that decides to convert a traditional plan to a hybrid plan on Jan. 1, 2008, and wants to provide certain additional benefits beyond the minimum required by PPA. This sponsor plans to provide the statutory A+B minimum benefit for all participants; however, the sponsor also plans to provide additional minimum benefits for the first five years following conversion to those who were older than age 50 at the time of conversion at an amount equal to the continued benefit accruals

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession

under the old traditional benefit formula. Based on the proposed regulations, Jan. 1, 2008, would not be the effective date of the conversion amendment. Rather, Jan. 1, 2013 (five years out) becomes the effective date of the conversion amendment since no future service accrues under the old traditional formula after that date. Based on the proposed regulations, this will then require a second A+B minimum on Jan. 1, 2013. This additional A+B minimum is not required by PPA and adds undue complexity to the plan's administration. Plan sponsors who choose to offer more than the statutory minimum, for example by offering any degree of grandfathering to older or longer service employees, should be permitted to do so (and encouraged to do so) without the penalty of added administrative complexity and cost.

Treatment of Variable Annuities – Recognized Investment Index

Variable annuity benefits are often included in pension plans that have other benefit structures that are fixed. Proposed regulations 1.411(b)(5)-1(b)(2)(ii) and (iv) provides that variable annuity benefit formulas based on the aggregate asset return of the entire plan are exempted from the protection-against-loss provision. However, when these types of benefits are not provided through annuity contracts but are provided through pension plans with trusts, the trust may be set up with sub-trust accounts in which the investment policies of the portion of the trust underlying the variable annuity benefit is often different from the rest of the trust. This is because the investment risk tolerance of the variable benefit portion of the plan (in which the participant bears the investment risk) may be different than the rest of the plan (in which the plan sponsor bears the investment risk).

The exemption should be expanded to permit plans with variable annuities to base the variable annuity portion of the plan on the investment experience of a designated portion of the trust fund. One way to accomplish this would be to expand the exemption to include a plan that adjusts variable benefits based on a specific pool of assets that is appropriately diversified but which might not represent the entire plan trust. If these assets are in a mutual fund or separate account within the plan, they might include investments in:

- U.S. Treasury securities,
- High quality corporate fixed income securities,
- Broadly diversified equity investments,
- S&P 500 equities, or
- Balanced funds that invest in a combination of the above.

If the plan doesn't have a separate account to hold assets for the variable annuity benefit, it might also be allowed to use a standard market index, such as:

- S&P 500 index,
- Russell 5000 index,
- Lehman Brothers aggregate long-term bonds, or
- Specified mixtures of these or other comparable indices.

A plan with a variable annuity benefit might have several cohorts of participants with different investment profiles, all of whom should be subject to the exemption. For example, plans might offer retired participants investments that are based on fixed income securities while they might offer active participants investments that are based on diversified equities.

Several types of assets are inappropriate for this type of plan, including:

- A single security, such as company stock,
- A single industry or sector fund,
- A highly speculative fund, or
- An index linked to a single industry.

Treatment of Variable Annuities – Threshold Interest Rate

Proposed regulation 1.411(a)(13)-1(d)(3)(iii)(B) provides that a minimum Assumed Interest Rate ("AIR") of 5% must be used in a variable annuity benefit formula in order to be treated as not providing larger benefits at normal retirement for a younger participant than a similarly situated older participant.. However, under a variable annuity benefit formula, the size of the benefit is based on the plan investments in addition to the AIR, and this should be considered in the final regulations.

If the variable annuity plan invests in less risky securities, such as Treasuries, the expected normal retirement benefits would be lower. If a plan invests with more risk, such as in equities, the expected normal retirement benefits would be higher, but greater volatility would be expected. However, both benefits should have the same current value since the possible higher return under one plan is offset by the cost of the volatility of that higher return and they have the same risk-adjusted rate of return.

Consideration should be given to looking at the AIR as either a nominal or real long-term risk-free rate. This would permit investment in less risky securities and thereby provide a more level benefit accrual than if the plan were to invest in a more risky equity-based portfolio. The nominal risk-free returns over recent history have often fallen between three percent and five percent. However, real risk-free rates (which are more stable) are less than two percent (by referencing Treasury Inflation Protected Securities or TIPS) and are usually less than three percent. Using a real risk-free rate doesn’t comply with the current proposed regulations, even though some plan sponsors may wish to use it to consistently preserve participants’ purchasing power.

In order to support variable annuity plans that do not want to be statutory hybrid plans but do want to provide stable fixed income with less risk, consideration should be given to defining these plans in some other way that does not involve a minimum AIR. However, if the regulations do maintain a minimum AIR, it should be lowered to something like three percent, the minimum AIR incorporated in the Treasury regulations to IRC Section 401(a)(9).

Definition of Market Rate of Return

PPA allows for broad latitude in hybrid design, requiring, for example, that a cash balance plan's interest credit quite simply not exceed "a market rate of return." The proposed regulations recognize that significant guidance on market rate of return is still needed. We offer our thoughts for consideration in developing that future guidance.

- Since PPA focuses on a "market rate of return," this suggests, as a starting point, that an interest-crediting method based on an investment available in the financial markets would, by definition, not exceed a market rate.
- We accept that some constraints on interest-crediting methods would be reasonable, such as a requirement to limit equity exposure to a "balanced-fund" type of investment or to apply a "prudent-man" investment standard, given that the tax system is providing support for the purpose of secure retirements.
- In addition to "pure" market rates, the final regulations should allow the use of some "quasi-market" rates. Notably, given the history with Notice 96-8 rates, those should be deemed as not exceeding market, even though such rates may not always be available in the market.
- Plans should be able to offer a single fixed rate of return up to some level, as noted in IRC Section 411(b)(5)(B)(i)(I).
- Plans should be able to use a variable return and, in addition, have a reasonable minimum. This reasonable minimum should be allowed without further limiting the variable piece to something less than market. This is permitted in IRC Section 411(b)(5)(B)(i)(I). The background section of the proposed regulations, however, suggests a different view: "the Treasury Department and the IRS have concerns that the use of a minimum guaranteed rate of return or the use of the greater of a fixed and a variable rate could result in effective interest crediting rates that are above market rates of return and are soliciting comments on how to avoid that result." While we agree that what constitutes a "reasonable" minimum requires careful thought, we believe the Code permits the existence of such reasonable minimum without adjustment to the other market-based rate the plan may use.
- Expanding on the last point, the minimum rate is primarily needed for backloading compliance under IRC Section 411(b); its purpose is not as a means to exceed a market rate and favor the young. In fact, the view in the proposed regulations appears to create the opposite effect. We believe Congress wanted up-to-market rates available and presumably would welcome larger benefits for older workers, such as through a graded pay credit schedule. The reasonable minimum interest rate facilitates the latter (again, to satisfy the backloading rules). If the reasonable minimum needed to support the grading can't be easily provided, the obvious fix may be to stick with a market rate on a flat schedule, thereby taking away the larger benefits for advancing age or service.

- We agree that what constitutes a reasonable minimum may also be dependent upon the basis for the interest crediting rate—e.g., the more equity exposure, the lower the minimum rate that could be viewed as reasonable.
- We note that the value of any reasonable minimum could be minimized by having it apply on a cumulative (rather than annual) basis, thereby mitigating some of IRS' concerns. It should not be applied on a basis more frequent than annual. But as we have just noted, a cumulative basis compounded annually would appear to fit the intent of the statute.
- The final regulations should permit a plan to provide a choice to participants of otherwise acceptable crediting rates. For example, life cycle-style choices should be permitted.
- We encourage that the final regulations allow for the use of the return on the underlying asset portfolio as a "market rate of return" as described in the preamble. Consistent with our comments above about variable annuity plans, it should also be acceptable to base the interest crediting on a subset of the assets, such as those in a separate account.

Code Section 411(d)(6) Relief

The proposed regulations provide very limited IRC Section 411(d)(6) relief for amendments described in Section 1107 of PPA. However, the proposed regulations anticipate that such relief will be available on amendments made pursuant to future guidance relating to what constitutes a market rate of return, as well as to amendments that are expected to exceed the current rates of return. While we are concerned with the limited scope of relief currently provided, we strongly agree with the stated intention to broaden this relief once further guidance is issued.

We urge that such future relief be as broad and flexible as possible. In particular, we recommend that the options that are available to plans that do not meet the yet-to-be-determined market rate standard also be available to plans that do meet this standard. As all plans have established their interest credit rates without the benefit of final regulations (and many prior to Notice 96-8), it seems appropriate to give all plans some ability to change the rates prospectively without onerous IRC Section 411(d)(6) considerations. We recommend that protection be granted whenever the new interest-crediting rate satisfies the definition of market rate of return.

Interaction of Proposed Regulations with IRC Sections 401(a)(4) and 415(b)

Some cash balance plan designs may have a benefit-crediting schedule that decreases as a function of age due to the limitations in IRC Section 401(a)(4) and Section 415(b). With the Section 415(b) limitation, it can happen by two means. The first is that no accrual would be allowed because the account balance is limited to the discounted present value of the Section 415(b) limit. The second is limiting the cash balance credits to the discounted present value of the IRC Section 415(b) limit and that such value decreases from age 62 to age 65.

Regarding IRC Section 401(a)(4), the minimum aggregate allocation gateway of regulation 1.401(a)(4)-9 causes a declining cash balance credit by age for highly compensated employees due to the interplay of the safe harbor testing assumptions, (e.g., 8.50 percent) and the interest crediting rate in a cash balance plan (e.g., 4.50 percent).

The concern, naturally, is that these situations may violate the similarly situated age discrimination rule under PPA. IRC Section 411(b)(1)(H) allows the Treasury secretary to provide guidance in this area:

> (v) Coordination With Other Requirements: The Secretary shall provide by regulations for the coordination of the requirements of this subparagraph with the requirements of subsection (a), sections 404, 410, and 415, and the provisions of this subchapter precluding discrimination in favor of highly compensated employees.

The proposed and withdrawn cash balance regulations from 2002 would have granted relief in this situation:

> Under these proposed regulations, a plan will not fail to satisfy section 411(b)(1)(H) or 411(b)(2) because of a limit on accruals or allocations necessary to comply with the limitations of section 415 or to prevent discrimination in favor of highly compensated employees within the meaning of section 401(a)(4).

We request that similar language be included in the final hybrid regulations.

We thank you for this opportunity to share our thoughts on these proposed regulations. We would be interested in meeting with you to answer any questions or discuss any of the concerns expressed in this letter. If you have any specific questions or would like more information, please contact Samuel Genson, the American Academy of Actuaries' pension policy analyst, at 202-223-8196. Thank you for your consideration of this matter.

Sincerely,

James F. Verlautz, FSA, EA, MAAA, FCA
Chair, Pension Committee
American Academy of Actuaries