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# Hybrid Plan Regulations Could Reinvigorate the Defined Benefit Plan System

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Treasury and the IRS recently issued long-awaited regulations governing cash balance and other hybrid pension plans.  Final regulations implement the intent of Congress in the Pension Protection Act of 2006 (the "PPA") to eliminate the so-called "whipsaw calculation" and permit more generous rates of return for employees and retirees.  Proposed regulations issued at the same time set forth a path for non-compliant plans to become compliant.  Private sector plans must adopt these changes before the first day of first plan year beginning in 2016.  Most significantly, however, is that the regulations ? for the first time ? specify the way in which employers can marry the efficiency of delivering benefits under through a defined benefit plan with the reduced financial volatility of a defined contribution plan.  In short, the regulations make possible a new design for retirement benefits that may prove attractive for employers and employees alike: the shared-risk pension plan.

**Whipsaw Is Dead.**  The PPA eliminated the practice, known as "whipsaw," of requiring hybrid plans to pay out lump sums in excess of the hypothetical account balance (or accumulated percentage of final pay) by projecting interest credits to normal retirement age and then discounting the resulting benefit to present value using statutory rates.  Whipsaw was objectionable on a number of grounds, which is why Congress eliminated it.  Perhaps its most objectionable feature is that it required affected hybrid plans to pay out larger lump sums to younger employees than to similarly situated older employees.  The proposed regulations imposed numerous restrictions on Congress's elimination of whipsaw that did not appear in the statute, and appeared to require affected hybrid plans to continue using the whipsaw calculation, for example, if they provided subsidized survivor or early retirement benefits.  The final regulations remove these restrictions and eliminate any requirement for any hybrid plan to continue using the whipsaw calculation.

**More Generous Fixed and Minimum Interest Credits.**  The PPA made clear that hybrid plans could periodically adjust a participant's hypothetical account balance (or accumulated percentage of final average pay) for the time value of money—for example, by crediting interest—as long as the rate of adjustment does not exceed a market rate of return.  A hybrid plan that credits interest has a number of options for doing so, including crediting only a single fixed rate of interest (e.g., 5%) or offering a variable rate of interest that is underpinned by a floor or minimum fixed rate of interest (e.g., the current yield on 30-year Treasury securities, but never less than 4%). The final regulations

increase the fixed and minimum rates that may be used as follows:

| Type of Rate | Highest Rate Permitted |
| --- | --- |
| single fixed rate | 6% |
| minimum annual rate if using rates in Notice 96-8 (such as 30-year Treasuries) | 5% |
| minimum annual rate if using 1st, 2nd, or 3rd segments | 4% |
| minimum cumulative rate | 3% |

Treasury and the IRS established these ceilings on minimum rates to ensure that the combination of the variable interest crediting rate and the fixed minimum rate would not, together, create an above-market rate.

**More Flexible Investment Rates of Return.** Another way for a hybrid plan to adjust a participant's hypothetical account balance for the time value of money is to credit the account with the rate of return on an investment, be it a single security or a diversified investment portfolio. Prior regulations permitted a plan to credit an investment rate of return, but limited the choices to the return on (1) all the assets held by the plan, (2) a diversified regulated investment company (such as an S&P 500 mutual fund), or (3) an annuity contract issued by an insurance company. One drawback to this approach is that it appeared to limit plans to crediting the same investment rate of return to all participants in the plan, even though individual participants might have vastly different investment horizons and appetites for risk (for example, the new hire just out of college vs. a long-term employee on the verge of retirement). The recently released regulations address this shortcoming by permitting a plan to (1) subdivide the plan's assets into separate pools with different asset mixes, (2) calculate the rate of return on each pool separately, and (3) credit participants with different rates of return by crediting them with the rate of return on one of the pools. To be eligible to do this, the each subset of plan assets must meet the following requirements: the subset of assets is diversified, no more than 10% of such assets are employer securities, and the assets approximate the liabilities for which the return is being credited.

However, certain limitations remain regarding investment rates of return:

**Limit on age or service grading.** Plans that credit an investment rate of return may apply the anti-backloading rules by projecting negative returns using a 0% interest rate. This projection might preclude a plan from providing pay credits (or similar principal-like credits) that increase with increased age or service.

**Difficult to Replace a RIC.** A plan that credits a rate of return on a regulated investment company ("RIC") may replace the RIC with another RIC without violating the anti-cutback rule if the initial RIC

ceases to exist and the replacement is the successor to the RIC (where a successor exists) or a RIC with similar characteristics. A rate of return based on a RIC may not be replaced with a different RIC merely because the first RIC begins to perform poorly or otherwise changes without ceasing to exist.

May Not Credit Based on an Index. A plan may not credit a rate of return based on an index, such as the S&P 500. Instead, the plan would need to credit the rate of return on a RIC that seeks to mirror an index, such as a specified S&P index mutual fund.

**Opportunity for Shared-Risk Pension Plans.** Traditional defined benefit plans require the employer to bear the risks associated with changes in interest rates, financial markets, and life expectancies: the benefits promised under traditional defined benefit plans do not vary based on these factors. In contrast, the benefits provided by defined contributions plans are based solely on the participant's account balance, which the participant typically must manage to address changes in the market, interest rate fluctuations, and the participant's life expectancy (which is not always easy to predict). A key feature of the final hybrid pension regulations permits a new type of plan design in which these risks are shared between the employer and the participant.

As noted above, the final regulations permit a hybrid plan to credit an investment rate of return. The benefits under a hybrid plan could therefore vary based on market experience. However, the plan would need to credit, at a minimum, a cumulative return of 0% interest (meaning that the participant receives, at a minimum, the sum of his or her pay credits without interest). In this manner, a participant would bear some investment risk, but would have some protection from the 0% cumulative floor. Furthermore, the plan would be required to offer an annuity form of benefit, providing a stream of payments for the life of the participant and, if married, his or her spouse. But, as described above, prior regulations required a one-size-fits all approach: the plan could credit a return based on an S&P 500 index fund, for example, but doing so for all participants, regardless of investment horizon, limited the attractiveness of this approach. The final regulations remedy this concern: different rates of return may be credited for different groups of participants based on separate subsets of plan assets. The regulations offer an example of how this might work: a subset of assets could be associated with participants based on years of service. For example, shorter service employees might be credited with a rate of return on a subset of plan assets that is invested less conservatively than a subset of assets associated with benefits for longer-service participants.

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