

The Latest on Cash Balance Plans

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Tom Sablak, CCA Strategies

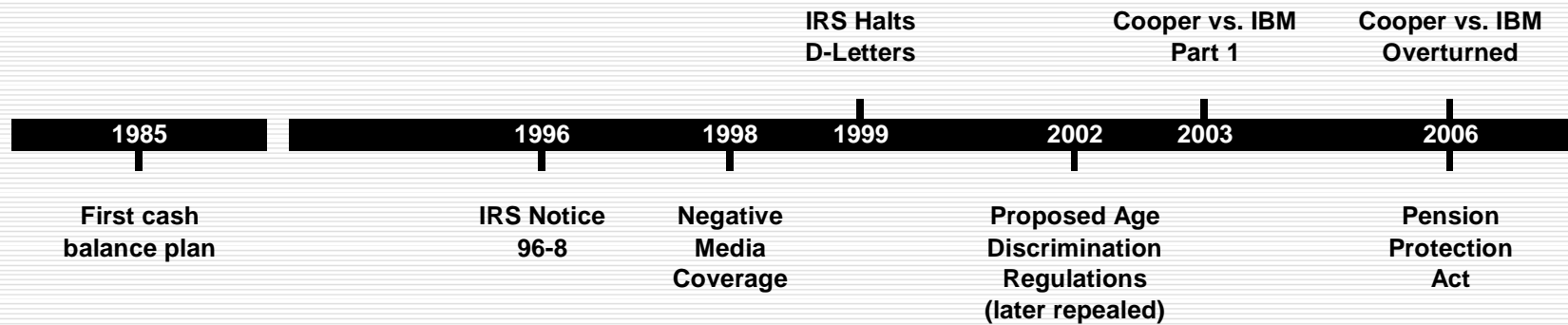
Agenda

- Cash Balance Plans – Overview
- Problem Areas
- Pension Protection Act of 2006
- Open Issues
- Key Court Cases

Overview – Cash Balance Plans

- Defined benefit (DB) plan that resembles a defined contribution (DC) plan
- Participants receive pay credits to a hypothetical account
- This “account” receives interest credits until paid out
- Employer is responsible for the promised pay and interest credits and bears the investment risk

Cash Balance Plans – Brief History



Problem Areas

- Age discrimination (legality)
- Whipsaw and lump sums
- Conversions and wearaway

Age Discrimination

- ERISA section 204(b)(1)(H)(i): a participant's rate of benefit accrual cannot decrease with age
- Claim: A pay credit, when expressed as a benefit payable at normal retirement age, is more valuable to a younger participant and is therefore not age-neutral
- Example: A 5% pay credit to a 30-year-old vs. a 6% pay credit to a 64-year-old

Age Discrimination (continued)

- Arguments for age discrimination
 - n ERISA §204(b)(1)(H)(i) references “the rate of an employee’s benefit accrual”
 - n IRC §411(a)(7) defines ‘accrued benefit’ as being “expressed in the form of an annual benefit commencing at normal retirement age”
 - n IRC §411(c)(3): optional forms must be actuarially equivalent to the SLA commencing at the normal retirement age
 - n Pay credits and account balances are notional

Age Discrimination (continued)

- Arguments against age discrimination
 - n Pay credits are age-neutral or else increase with age
 - n Interest crediting rate is also age-neutral
 - n Naturally, interest compounds over a longer period for younger employees
 - n Extending the age discrimination logic, all DC plans would be discriminatory

Whipsaw and Lump Sums

- §1.417(e)-1(d) states that the present value of any optional form of benefit cannot be less than the present value of the normal retirement benefit
- Claim: Certain cash balance plans that pay lump sums equal to the account balance may violate 417(e) if the interest crediting rate $>$ the minimum lump sum basis

Whipsaw and Lump Sums (continued)

- IRS Notice 96-8 proposed a list of variable interest rate bases (including margins) deemed to be no greater than the 30-year Treasury for plans with frontloaded interest credits
 - n Allows for a lump sum equal to the account balance?
 - n “Safe harbors”? What about non-conforming rates?
 - n “Legitimated” cash balance plans?

Conversions and Wearaway

- Claim: If the opening cash balance account is set equal to the present value of the prior plan accrued benefit and interest rates subsequently drop, it may take several years for the participant to accrue new benefits under the cash balance plan
 - n Also called “benefit plateau”

Conversions and Wearaway (continued)

- The media became highly critical of wearaway
- What to do with early retirement subsidies?
- A+B approach is best?

Pension Protection Act of 2006

- Section 701 of PPA'06 adds identical language to:
 - n ERISA section 204(b)
 - n IRC section 411(b)
 - n ADEA section 4(i)
- Section 702 instructs Treasury to issue regulations (within 12 months) on conversions resulting from mergers and acquisitions

Key Areas of PPA'06

- “Applicable Defined Benefit Plans”
- Age discrimination rules not violated
- Elimination of whipsaw
- Wearaway is prohibited
- 3-year vesting requirement
- Prospective guidance only (after 6/29/2005)

“Applicable Defined Benefit Plans”

- New sections:
 - n ERISA §203(f)(3)
 - n IRC §411(a)(13)
- “DB plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account ... or as an accumulated percentage of the participant’s final average compensation”
- Treasury instructed to issue regulations which clarifies this definition

Age Discrimination

- A plan does not violate ERISA §204(b)(1)(H) “if a participant’s accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant”

Age Discrimination (continued)

- Accrued benefit comparison can disregard:
 - n Early retirement subsidies
 - n Certain offsets (e.g., floor-offset arrangements)
 - n Permitted disparity under IRC §401(I)
 - n Indexing that does not reduce the accrued benefit
 - Variable annuity plans are excluded

Age Discrimination (continued)

- “Similarly Situated”: except for age, identical with respect to:
 - n Service
 - n Compensation
 - n Position
 - n Date of hire
 - n Work history
 - n Any other respect

Age Discrimination (continued)

- "Accrued Benefit" can be expressed as:
 - n Annuity payable at NRA
 - n Balance of a hypothetical account **
 - n Current value of the accumulated percentage of the employee's final average compensation **
- Fixes, prospectively, the age discrimination problem for most typical cash balance designs

Whipsaw/Interest Credits

- Lump sum equal to account balance is ok
- Maximum interest credit can be no greater than a “market rate of return”
- May include:
 - n A reasonable guaranteed rate of return
 - n Greater of a fixed or variable rate of return
- Treasury may provide regulations regarding the “market rate”
 - n Modify IRS Notice 96-8?

Whipsaw/Interest Credits (continued)

- “Preservation of Capital” clause for interest credits less than 0%:
 - n Account balance at any time must at least be equal to sum of pay credits (plus opening balance)
 - n Negative interest credit might occur in plans that grant equity returns

Wearaway

- For post-6/29/2005 conversions (“applicable plan amendments”), the minimum value of an accrued benefit under a cash balance plan equals the sum of (“A + B”):
 - n A: Accrued benefit for years of service up to the date of conversion; plus
 - n B: Accrued benefit for years of service after conversion

Wearaway (continued)

- If the participant becomes eligible for subsidized early retirement benefits after conversion, then the “part A” benefit must include the value of that subsidy
 - n Can subsidy be somehow included in the value of the opening balance?

Vesting Requirement

- Cash balance plans must provide for a 3-year cliff vesting
 - n 100% vested after 3 years of service

Other Requirements

- Terminated cash balance plans
 - n Variable interest crediting rate must be converted to a fixed rate
 - Equal to the average interest crediting rates over the 5-year period ending on the termination date
 - n Annuity conversion basis (mortality and interest) as of termination date applies
 - If interest basis is variable, 5-year average applies

Effective Dates

Effective Dates for PPA '06 Provisions Related to Hybrid Plans

	Existing Plans	Conversions After 6/29/2005
Age Discrimination	6/29/2005	Immediate
Interest Credits	"Years beginning in 2008"	Immediate?
Wearaway/Conversions	No guidance	Applies to all conversions adopted and effective after 6/29/2005
3-year Vesting Requirement	"Years beginning in 2008"	Immediate?
Distribution of Account Balance as Lump Sum	All distributions after 6/29/2005	All distributions

No Inference

- PPA rules do not create an inference as to whether existing cash balance plans were/were not in compliance with new law
 - n Age discrimination
 - n Lump sums
 - n Conversions
- Senate version of legislation was adopted

Open Issues

- Things we already know about:
 - n Guidance on “market rate of return” (extension of Notice 96-8?)
 - n Clarification on “applicable DB plans”
 - n Immediate application of vesting and interest crediting rules for post-6/29/05 and pre-2008 conversions?
 - n What does “years beginning in 2008” mean for vesting and interest crediting rules? Is earlier adoption possible?

Open Issues (continued)

- Other issues:

- n Processing of pending determination letters
- n How to apply “similarly situated” rule for plans that are not strictly traditional DB, cash balance, or pension equity (e.g., plans in which choice was provided)
- n Is the “preservation of capital” clause applied annually or at BCD?

Open Issues (continued)

- Other issues (continued):
 - n How are future early retirement subsidies handled?
 - n Post-6/29/2005 conversions that have “defects”
 - n Application of 3-year vesting to “mixed” plans
 - n Application of 3-year vesting for former employees

Court Cases – Lump Sums

- Can cash balance plans pay the hypothetical account balance as the lump sum?
- Interest crediting rates after termination?
- Key cases:
 - ∅ Lyons vs. Georgia-Pacific
 - ∅ Berger vs. Xerox Corporation
 - ∅ Laurent vs. PriceWaterhouseCoopers

Lyons vs. Georgia-Pacific

- Georgia-Pacific cash balance plan
 - n Lump sum equals the account balance
 - n Interest credits at PBGC immediate rate plus 75 bps
 - n Lyons' account balance was \$36,100; "round-trip" calculation gave \$49,300
- In 1999, a US District Court in Georgia dismissed the case
 - n Lyons had no legal right under ERISA to claim the extra benefits
 - n Interest crediting rate did not run afoul of any law

Berger vs. Xerox Corporation

- Xerox cash balance plan
 - n Interest credits based on one-year Treasuries
 - n Exception: participants who terminated prior to age 65 received lump sums reflecting future interest credits at the (lower) PBGC rate
- The US Court of Appeals for the Seventh Circuit ruled in 2003 that an accrual in a cash balance plan equals the pay credit plus future interest credits on that pay credit
 - n Cannot change the interest crediting rate basis
- Xerox settled with the former plan participants

Laurent vs. PwC

- PwC cash balance plan
 - n Participants are vested after 5 years of service
 - n NRA not a specific age: participants who leave the company after 5 years could elect to receive their “normal retirement benefit” as a lump sum
- The US District Court (Southern District of New York) ruled in September 2006 that the NRA cannot be defined solely with regard to years of service
 - n NRA is instead age 65 since the plan does not provide another valid age

Laurent vs. PwC (continued)

- Key results:

- n The cash balance plan does not discriminate on age
 - n The whipsaw calculation is required for participants who terminated prior to age 65 (agreed with plaintiffs)

Court Cases – Age Discrimination

- Do conversions to cash balance plans discriminate against older workers?
 - n Wearaway
 - n Loss of future benefits
- Do cash balance plans operate in a discriminatory fashion?
 - n Rate of accrual
- Does ERISA §204(b)(1)(H) only apply post-NRA?
 - n IRS has indicated “no”
 - n Some courts have indicated “yes”

Court Cases – Age Discrimination (continued)

- Key cases – in favor of cash balance plans:
 - ∅ Eaton vs. Onan Corporation (2000, Indiana District Court)
 - n Campell vs. BankBoston (2003, Massachusetts District Court)
 - n Tootle vs. ARINC (2004, Maryland District Court)
 - n Register vs. PNC Financial Services (2005, Pennsylvania District Court)
 - ∅ Cooper vs. IBM (2006, 7th Circuit Court of Appeals)
 - n Laurent vs. PwC (2006, New York District Court)
 - ∅ Drutis vs. Quebecor World (2006, Kentucky District Court)
- Court sided with plaintiff:
 - ∅ Cooper vs. IBM (2003, Illinois District Court)
 - n Richards vs. FleetBoston (2006, Connecticut District Court)

Eaton vs. Onan Corporation

- Onan cash balance plan
 - n Adopted cash balance plan in 1994 retroactive to 1989
 - n Design included minimum and grandfathered annuity benefits
- First federal case dealing with age discrimination with regard to a cash balance plan
- US District Court (Southern District of IN) sided with Onan in 2000: the rate of benefit accrual in a cash balance plan is based on the annual change in the hypothetical account and not the age 65 annuity

Cooper vs. IBM — Part 1

- IBM cash balance plan:
 - n Adopted a cash balance plan in 1999
 - n 5% pay credits for all participants
 - n Interest credits based on one-year Treasuries
- US District Court (Southern District of IL) agreed with the plaintiffs in 2003 that the IBM plan violates ERISA age discrimination rules
 - n Rate of benefit accrual determined by reference to age 65 annuity
- Contradicted the decision in the Eaton vs. Onan case (same circuit)
- Case was appealed in the US Court of Appeals for the Seventh Circuit

Cooper vs. IBM — Part 2

- On appeal, a three-judge panel of the US Court of Appeals ruled in favor of IBM (August 2006)
- First case decided at the appeal level
- “Treating the time value of money as a form of discrimination is not sensible.”
- “The phrase ‘benefit accrual’ reads most naturally as a reference to what the employer puts in ... while the phrase ‘accrued benefit’ refers to outputs after compounding.”
- “...there is no statutory difference between the treatment of economically equivalent defined benefit and defined contribution plans.”

Cooper vs. IBM — Part 2 (continued)

- "Like a defined contribution plan, a cash-balance plan removes the backloading of the pension formula; older workers (accurately) perceive they are worse off under a cash-balance approach than under a traditional years-of-service-times-final-salary plan. But removing the a feature that gave extra benefits to the old differs from discriminating against them. Replacing a plan that discriminates against the young with one that is age-neutral does not discriminate against the old."

Cooper vs. IBM — Part 2 (continued)

- What does this mean?
 - n Great news for cash balance advocates
 - n Plaintiffs' lawyers may appeal for a rehearing by the full Seventh Circuit
 - n May also appeal to the Supreme Court
 - n There are other cash balance age discrimination cases in progress

Drutis vs. Quebecor World

- World Color (prior to merger with Quebecor Printing) brought acquired Rand McNally employees into cash balance plan in 1997
 - n Gave employees choice between cash balance plan and traditional DB plan
- US District Court (Eastern District of KY) sided with World Color in September 2006 that the cash balance plan was not age discriminatory
 - n Pay credits are age-neutral
 - n ERISA statute does not apply pre-65

Drutis vs. Quebecor World (continued)

- “This Court joins the majority of courts in rejecting an interpretation of ‘rate of benefit accrual’ for cash balance pension plans as being the same as ‘accrued benefit’ and, instead, adopting a definition consistent with changes in account allocations or account balance.”
- “When plaintiffs have a choice between the greater of their pension benefits calculated under their old defined benefit plan or their new cash balance plan, and they choose the old plan, they have suffered no injury as the result of the company’s conversion to the new cash balance plan.”

Summary

- Overall, 2006 has been a pretty good year for cash balance plans
 - n PPA
 - n Favorable court decisions
- What's next?
 - n D-Letters?
 - n More court decisions (2nd, 3rd, and 9th Circuits)?
 - n Corrections for existing plans?
 - n IRS/Treasury regulations?
 - n More conversions?
- Questions?