



FINAL RETIREMENT LEGISLATION SHOULD INCLUDE
COMPREHENSIVE CLARIFICATION OF THE VALIDITY OF HYBRID PLANS
WITHOUT COSTLY MANDATES

It is critical that Congress clarify that hybrid plans are, and have always been, valid, non-age discriminatory plans.

- Hybrid plans provide contribution credits or other benefits that are a uniform percentage of pay (such as 5% of pay) or that are actually larger for older, longer service employees. Employees participating in hybrid plans and plan sponsors need Congress to clarify that it is not age discriminatory to contribute the same percentage of compensation (or an increasing percentage based on age) on behalf of all plan participants.
- If Congress clarifies the validity of hybrid plans, all employees will receive exactly what they were promised in all plan-related documents. Nothing earned is taken away.
- The plaintiffs in the hybrid plan litigation are actually asking for windfalls that are far greater than any benefits ever reflected in the plans. For example, because a 25-year old would receive 40 years of interest by age 65, the 64-year old is claiming to be entitled to at least 40 years of interest by age 65 also.
- The plaintiffs' windfalls would generally at least triple the liabilities of the hybrid portion of a plan. This would lead to many unnecessary plan freezes.
- The Treasury Department has repeatedly recognized the validity of hybrid plans by issuing guidance as to how they work and by approving large numbers of individual plans. And with one exception, hybrid plans have been held valid by the courts. To undermine employers' reasonable reliance on the lawfulness of hybrid plans would be a devastating blow to the voluntary retirement system.
- Prospective legislation does not address the risk of devastating and unfair retroactive liability.
- It is critical that comprehensive legislation clarify the law for all plans, including those currently included in litigation. The plans in litigation have the exact same type of benefit structure as the plans not in litigation. It would not be fair or appropriate to treat a plan or company differently purely on the basis of whether they have been sued by plaintiffs seeking an unjustified windfall.

The comprehensive legislation being requested would not have any effect on conversion issues.

- The conversion issue most frequently raised is wear-away. Wear-away is an often misunderstood term. It is frequently used to describe the benefit plateau effect that some employees can experience in conjunction with a hybrid conversion. The main concern raised relates to wear-away caused by early retirement subsidies.
- “Wear-away caused by early retirement subsidies” works as follows. Assume that a traditional defined benefit plan is converted to a cash balance plan. Assume further that, as of the date of conversion, the present value of Employee A’s normal retirement benefit commencing at age 65 is \$50,000. Accordingly, Employee A’s opening account balance in the cash balance plan is set at \$50,000. However, if Employee A, who is age 55, were to terminate employment immediately, he would be eligible for a subsidized early retirement benefit with a present value of \$60,000 under the traditional benefit formula. Even though the plan has been converted to a cash balance plan, the law requires that the employee receive the greater of the \$50,000 cash balance plan account (which will grow with contribution credits and interest) or the frozen traditional benefit. As noted, because of the subsidy, the traditional benefit is worth \$60,000, though the subsidized part of the benefit will become less valuable every year that the employee works until the subsidy disappears at age 65.
- In this example, however, it would generally not make sense to set Employee A’s opening account balance at \$60,000, since Employee A may not retire early and qualify for the subsidy.
- Wear-away refers to the fact that in the initial years of the cash balance plan, the benefit that Employee A would be entitled to upon termination of employment would not grow. This occurs because the value of the subsidized benefit under the prior plan formula, should the employee terminate employment, is still the higher of the two benefits. For example, if contribution credits and interest for Employee A in the first year of the cash balance plan totaled \$5,000, Employee A’s cash balance account would be \$55,000 after a year. If the frozen subsidized traditional benefit is still worth \$60,000, the employee is entitled to \$60,000 because it is the higher of the two benefits – the hybrid plan benefit has not yet exceeded what is due the employee under the traditional plan formula. This is wear-away: a period of time during which an employee earns no new net benefits, attributable in some cases to a change in benefit formula.
- Wear-away is a common method of moving from one benefit formula to another benefit formula in order (1) to avoid a lengthy period during which both formulas must be maintained at considerable administrative cost, and/or (2) to create a uniform benefit structure for two or more groups with different prior formulas. Wear-away has been expressly approved in IRS regulations and arises in many contexts other than conversions.

- Under the legislation requested by the employer groups, the validity of wear-away caused by early retirement subsidies would be left to the courts. On the other hand, some advocates of mandates have asked for a retroactive ban on all forms of wear-away in conversions, including a retroactive ban on wear-away caused by early retirement subsidies.
 - The law in effect today is very clear that wear-away caused by early retirement subsidies does not constitute age discrimination: “A plan shall not be treated as failing to meet the requirements of [the age discrimination prohibition] solely because the subsidized portion of any early retirement benefit is disregarded in determining benefit accruals” (from Code section 411(b)(1)(H)(iv), ERISA section 204(b)(1)(H)(v), and ADEA section 4(i)(6)).
 - It would be patently unfair to change the law retroactively to impose enormous new liabilities on companies.
 - The trend toward freezing defined benefit plans has clearly been accelerating. If Congress were to send companies a message that company liabilities can be dramatically increased retroactively, the trend would undoubtedly become a stampede. Such freezes would be far worse for far more employees than any wear-away issue.
 - Employers have already addressed their employees’ very real transition concerns in ways finely tuned to their own plans and workforces. The vast majority of employers have provided very significant transition benefits in connection with conversions. In fact, many recent hybrid conversions have actually increased the employer’s retirement plan costs. See, e.g., Coronado & Copeland, *Cash Balance Plan Conversions and the New Economy* (2003) (issued by economists at Federal Reserve Board, not by Board itself); *Hybrid Pension Conversions Post-1999: Meeting the Needs of a Mobile Workforce* (Watson Wyatt Worldwide 2004). In fact, an AARP study found that “transition provisions are very common and were adopted by 23 of the 25 plans examined”, which were the 25 largest cash balances plans. Beller, *Transition Provisions in Large Converted Cash Balance Pension Plans* (October 2005) (study prepared for AARP).

It is a voluntary system.

- As noted, companies have been leaving the defined benefit plan system at an accelerating rate. If costly new mandates are added to plans, either retroactively or prospectively, it will increase these departures and thus severely hurt participants. In short, mandates intended to help participants will badly hurt them. If that happens, tomorrow’s concern will be the alarming lack of employer-sponsored retirement plans.