October 31, 2023

PROPOSALS FOR ENHANCING RETIREMENT SECURITY BY STRENGTHENING THE SINGLE-EMPLOYER DEFINED BENEFIT PLAN SYSTEM

The decline in the single-employer defined benefit plan system in the past 25 years has been alarming. For example, in 1998, 49% of the Fortune 500 companies offered a traditional defined benefit plan that was open to new salaried employees. By 2021 that number had declined to 3%.[1] Moreover, the decline accelerated starting in 2006, when premiums payable to the Pension Benefit Guaranty Corporation (PBGC) began increasing dramatically. From 1998 to 2006, the number of open traditional defined benefit plans decreased by about 50%; from 2006 to 2021, the decline was 87%.[2]

This paper includes:

- A brief description of the cause of the decline of the defined benefit plan system.
- A discussion of the role of PBGC premiums in causing that decline.
- Proposal No. 1, which adjusts premiums based on the PBGC's funded status, so that if PBGC is so well funded that it does not need the current level of premiums, premiums would be reduced.
- Proposal No. 2, which takes premium increases and decreases off budget, because premiums cannot be used for any purpose other than paying benefits and PBGC administrative costs.
- Proposal No. 3, which prevents an anticipated wave of plan terminations by permitting non-terminated plans to use surplus assets in a manner similar to what would be permitted if the plan were terminated.

[1] "A Historical Look at the Retirement Plans of Today's Fortune 500, 1998-2021, WTW, March 2022.

[2] Id.

- Proposal No. 4, which permits unusable surplus assets in retiree health 401(h) accounts in pension plans to be used to shore up the retirement benefits in the pension plan and to provide other benefits.

- Proposal No. 5, which protects employers by reducing funding volatility and protects participants from benefit restrictions that take away earned rights.

- Proposal No. 6, which facilitates a growing type of traditional defined benefit plan, where benefits are adjusted to some extent based on plan asset returns.

- Proposal No. 7, which updates the accounting rules for market-based cash balance plans to base the valuation generally on the value of the notional account balances, which would materially improve the accuracy of the valuations.

- Proposal No. 8, which corrects a glitch in the law that punishes plans that provide more generous lump sum benefits.

CAUSES OF THE DECLINE

The decline in the defined benefit plan system was studied closely by the office of the PBGC Participant and Plan Sponsor Advocate ("the Advocate") in 2017 and 2018, which examined the cause of risk transfer activity. (Risk transfers are generally ways of shrinking or terminating a defined benefit plan by purchasing annuities or paying lump sums to discharge pension obligations.)

The study found that the top factors influencing plan sponsors' propensity towards risk transfer activity are accounting and earnings volatility, balance sheet liability management, funding volatility and PBGC premiums.[3] Two of these factors are within Congress' control: funding volatility and PBGC premiums, which have skyrocketed since 2005. Our proposals, as set forth below, address these issues directly.

Excessive PBGC Premiums are Driving Plan Sponsors out of the Defined Benefit System

As a result of the PBGC having run deficits in prior years, single-employer plan premiums were raised to extreme levels that are clearly no longer needed in light of the extraordinarily high levels of surplus in PBGC's single-employer plan system – currently $36.6 billion and projected to be $63.6 billion by 2032.[4] In fact, PBGC projects

[3] 2017 Annual Report of the PBGC Participant and Plan Sponsor Advocate

[4] https://www.pbgc.gov/sites/default/files/documents/fy-2022-projections-report.pdf

that by 2032, it will likely have $117.5 billion of assets and $53.9 billion of liabilities, resulting in *an astounding funding ratio of 218%*.[5]

PBGC's flat rate premium and variable rate premium have both more than quintupled since 2005 – the flat rate from $19 to $96 (indexed) and the variable rate from .9% of underfunding to 5.2%. In fact, under current law, *some plans that are well-funded on a funding basis could owe as much as $748 per participant in 2023.*

These excessive premiums are applying at a time when PBGC's exposure to risk is at a long-time low. In its 2022 annual report, PBGC estimated its "reasonably possible exposure" at $52 million, by far the lowest in many years – for example, this figure was $176 million in 2020 and $238 million in 2017. These "reasonably possible" liabilities rarely materialize in any material amounts. For example, since PBGC had a deficit of $10.9 billion in 2017 and now has a $36.6 billion surplus, it is clear that the reasonably possible exposure of $238 billion in 2017 did not become a reality.

The Advocate in her 2022 annual report recommended that "discussions should consider topics such as current premium levels and whether PBGC can or should raise the question regarding whether the high level of premiums undermines its mission to maintain the defined benefit system." The 2022 report included the following quotes from plan sponsors when asked about PBGC premium levels as part of the Office of the Advocate's 2018 Pension De-Risking Study:

> "The PBGC premiums have inflated way higher and way faster than anything that would be considered reasonably acceptable."
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> "[T]he higher the premiums go, the threshold for where we'll de-risk, it just gets closer. It's purely [an] economic thing."
>
> "For us, if we freeze our plan, it will be no question because of the PBGC premiums."
>
> "We justified our [retiree annuity purchase] strictly on PBGC premium savings."

PROPOSALS TO ADDRESS THE DECLINE

As the decline of the single-employer defined benefit plan system has continued, many have discussed the need to incorporate elements of the defined benefit plan system into the defined contribution system. We support those efforts. But the most effective way to promote the beneficial components of the defined benefit system is to strengthen that system.

[5] Id.

Strengthening the defined benefit system would (1) give participants access to guaranteed income for life, (2) ensure that spouse's rights to retirement benefits are protected, (3) protect participants from market fluctuations, and (4) allow retirees to use their defined contribution savings to address unexpected retirement costs, while relying on their defined benefit plan income to pay for everyday expenses.

PROPOSAL NO. 1

Automatically adjust single-employer plan premiums based on PBGC's funded status

In light of the harm being done by the excessive PBGC premiums, **the Council proposes a set of much-needed reforms described below, based almost entirely on a widely bipartisan bill (with some noted updates):** the Rightsizing Pension Premiums Act of 2017 (H.R. 3596, or "Kelly/Kind")[6] introduced in the 115th Congress by Representative Mike Kelly (R-PA) and then-Representative Ron Kind (D-WI) **with 136 bipartisan cosponsors**.

The most appropriate solution to the current excessive premium regime is to enact an automatic system that adjusts single-employer plan premiums based on the funded status of PBGC itself. Accordingly, under this proposal, PBGC's funded status would be determined by the U.S. Treasury Department under the same rules that Congress applies to private pension plans, except that interest rate stabilization would not apply.[7]

Under this proposal, premium levels would logically be reduced when PBGC is very well funded, as it is now, and increased back to current law rules if PBGC's funded status were to decline significantly.

- **Current law premium levels would apply if PBGC is under 90% funded.** The current levels of a $96 (indexed under the current rules) flat-rate premium and a 5.2% (not indexed) variable rate premium would be in effect whenever the average funded status of PBGC's single-employer plan program was less than 90% during the two fiscal-year period ending in the plan year two years prior to the current plan year. So, for example, if the current plan year is calendar year 2028, the two fiscal years taken into account would be the fiscal years ending September 30, 2025 and September 30, 2026. This multi-year lookback provides stability and predictability.[8] This same lookback rule applies to all the

[6] https://www.congress.gov/bill/115th-congress/house-bill/3596

[7] For this purpose, PBGC's liabilities would be based on all benefits that PBGC is required to pay, a broader definition than was used in Kelly/Kind.

[8] Kelly/Kind had a one-year lookback.

thresholds described below. In these circumstances, the current-law per-participant cap on the variable rate premium with current-law indexing would apply ($686 in 2024 plus future indexing).

- **Premium levels would be reduced if PBGC is at least 90% funded but not 100% funded.** If such average funded status was at least 90% but less than 100%, PBGC premiums would revert to a flat-rate premium of $64 (indexed starting in 2025),[9] a variable rate premium of 2.8% (not indexed),[10], and a $500 per-participant cap on the variable rate premium (indexed starting in 2025).

- **Premium levels would be reduced if PBGC is at least 100% funded but not 110% funded.** If such average funded status was at least 100% but less than 110%, PBGC premium levels would revert to a flat-rate premium of $30 (indexed starting in 2025), a variable rate premium of .9% (not indexed), and a $500 per-participant cap on the variable rate premium (indexed starting in 2025).

- **Premium levels would be reduced if PBGC is at least 110% funded but not 125% funded.** If such average funded status was at least 110%, PBGC premium levels would revert to a flat-rate premium of $19, a variable rate premium of .9%, and a $500 per-participant cap on the variable rate premium, none of these figures indexed.

- **A premium holiday – no premiums – would apply if PBGC's average funded status is at least 125%.[11]** Also, for any year for which Treasury does not measure PBGC's financial status, PBGC shall be deemed to be 125% funded.[12] (Since PBGC's average funded status over two years must be 125% to give rise to a premium holiday, this deeming rule will rarely if ever trigger a premium holiday.)

Congress' ability to modify premium levels would not be affected in any way. Congress remains able at any time to (1) adjust premiums regardless of PBGC's funded status or (2) modify any feature of the proposal, such as raising the 90% funded trigger.

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[9] The year in which indexing starts under this proposal has been updated from Kelly/Kind to reflect the fact that it is now six years later.

[10] In light of the provision in SECURE 2.0 recognizing that indexing a variable rate is not appropriate, the proposal does not index any of the variable rate premium rates.

[11] This last bullet was not in the Kelly/Kind bill, but much has changed since the Kelly/Kind bill in the summer of 2017. At that time, PBGC's single-employer plan program had a deficit of $20.6 billion; now the program has a surplus of $36.6 billion, which is expected to continue to grow, as PBGC itself projects.

[12] This was not in Kelly/Kind.

PROPOSAL NO. 2:

Premium increases and decreases should be "off budget"

As under the Kelly/Kind bill, since PBGC premiums cannot be used for any other governmental purposes, single-employer plan premium increases or decreases would not be taken into account in determining the budget effects of legislation. This concept is also incorporated in the Pension and Budget Integrity Act introduced in recent years.

PROPOSAL NO. 3:

Why many plans may soon be terminated and a proposal to reduce such terminations

For many years, single-employer defined benefit plans in the aggregate have had substantial underfunding, largely due to very low interest rates. This has led to very large contributions to such plans, but because of the low interest rates, the underfunding persisted for many years despite the large contributions.

Dramatic Rise in Interest Rates

Interest rates have risen dramatically, thereby decreasing the value of pension liabilities. Pension liabilities are valued using corporate bond interest rates, and the IRS publishes spot corporate bond interest rates on a monthly basis. https://www.irs.gov/retirement-plans/minimum-present-value-segment-rates For July of 2023, the short-term, mid-term, and long-term rates were 5.35%, 5.28%, and 5.10%, respectively. By contrast, in December of 2020, those three rates were .51%, 2.26%, and 3.01%, respectively. Even before the pandemic, the three rates were far below current rates; for example, for August of 2019, the three rates were 2.09%, 3.00%, and 3.61%.

Dramatic Rise in Funded Status

The increase in interest rates has had such a strong effect on pension plans' funded status that it has more than overcome the adverse asset returns of 2022. Milliman publishes a monthly pension funding index based on the funded status for accounting purposes of the 100 largest corporate defined benefit plans. As of July 31, 2023, ***the funded ratio for those 100 plans was 103.6%, with a surplus of $47 billion.***[13]

To put this in context, between 2002 and 2021, there was only a brief period in 2006 and 2007 when the Milliman 100 had a surplus; in all other years, the Milliman 100 had a funding deficit, often exceeding $200 billion. So we are now in new territory, with

[13] https://www.milliman.com/en/insight/pension-funding-index-august-2023

large surpluses for many large plans (though certainly not all plans, some of which still have material deficits).

Data from Morgan Stanley reinforces the point that pension plans are very overfunded.[14] As of April 30, 2023, the report estimated that "S&P 1500 pension-heavy companies are operating at a median status of 108%." Based on Morgan Stanley data, this is about 10 percentage points higher than at any time since 2001.

This overfunding is triggering a huge increase in pension risk transfers. For example, Morgan Stanley found that pension risk transfers, which were already very prevalent, increased 42% in 2022. So we are looking to the future and, as discussed below, strongly believe that there may be a broad wave of pension plan terminations in our near future unless reforms are enacted.

Implications of Many Large Plans Having Large Surpluses: A Likely Wave of Plan Terminations

Under current law, surplus assets in a defined benefit plans are permitted to be used to pay for nonelective contributions to a defined contribution plan, ***but only if the plan is terminated.*** Briefly, if a defined benefit plan is terminated, Code Section 4980(d) permits surplus assets to be contributed to a "replacement plan," including a defined contribution plan. In order to be a replacement plan, at least 95% of the active participants in the terminated plan who are still employed by the employer must be active participants in the replacement plan. The surplus may be allocated to participants as nonelective contributions to the defined contribution replacement plan over seven years.

Thus, under Section 4980, if plans want to use the large surplus that is building up ($47 billion from the top 100 plans alone), they generally have to terminate the defined benefit plan. For this reason, we could very easily see a wave of very large plan terminations in the next few years; in fact, it would be surprising if such a wave did not occur, especially since so many defined benefit plans are completely frozen (46% of the Fortune 500 have frozen their plan from 1998 through 2021) or closed to new hires (another 22%). WTW, A Historical Look at the Retirement Plans of Today's Fortune 500 1998-2021 (March 2022). If by terminating, an employer can tap into a multi-billion dollar surplus to pay for defined contribution plan contributions, that can be a powerful incentive to terminate.

Policy Implications of Plan Terminations

There are different views regarding the policy implications of plan terminations. Based on hard data, participant benefits are actually safer in the case of terminations

[14] Morgan Stanley Research, *Snapshot: US Pension Plans Remain Overfunded*, May 7, 2023.

than they are remaining in the pension system.[15] But we also believe that defined benefit plans can for many workforces play a vital role in providing for retirement security. The termination of a defined benefit plan, even a frozen plan, makes it far less likely that the sponsoring employer will ever have an active defined benefit plan again. Thus, the expected wave of plan terminations is a serious issue for policymakers to evaluate.

Proposal

In order to avoid a material incentive to terminate, our proposal would permit plan sponsors to use surplus assets in a non-terminated defined benefit plan to pay for defined contribution plan benefits to the same extent that such surplus could be used if the plan had terminated under Code Section 4980, subject to the following conditions:

- **100% vesting of all benefits under the defined benefit plan**: If the defined benefit plan were terminated, all benefits must be 100% vested. If the surplus assets are used to fund a replacement plan under this proposal, benefits under the defined benefit plan must be vested to the same extent as if the plan had been terminated.

- **No reduction of benefits under the defined contribution plan for an extended period:** If surplus assets are used to fund a replacement plan under this proposal, benefits under the replacement plan may not be reduced during (1) the allocation period (i.e., the period during which the surplus is used to fund the replacement plan), plus (2) the next four years after the allocation period. This "maintenance of effort" rule is modeled after a similar rule under Code Section 420, which governs the transfer of surplus defined benefit plan assets to retiree health and life accounts. ***This is far more protection than would exist if the defined benefit plan were terminated; in the case of a plan termination, there is no restriction on reducing benefits under the replacement plan.***

- **Definition of surplus assets:** To deter terminations, the definition of surplus assets must not be too restrictive. For example, if "surplus assets" is defined as the excess of plan assets over 125% of plan liabilities, then this is likely to be ineffective in deterring plan terminations.

    - **Example:** Assume that a plan has $100 million of liabilities and $125 million of assets. Under a 125% rule, this plan could not use any of the surplus assets. Although the cost of terminating a plan varies materially, the cost of most plan terminations ranges between 105% and 110% of the liability of the plan, measured using the rules used to determine PBGC premiums (i.e., valuations based on asset fair market values and spot

[15] https://www.americanbenefitscouncil.org/pub/?id=176CFD9B-1866-DAAC-99FB-5894C9EF628C

interest rates). So under a 125% rule, the employer would likely simply terminate the plan to gain access to all or most of the surplus.

- **Proposal:** In light of the objective to deter terminations, this proposal sets the definition of surplus assets as the excess of plan assets over 110% of the value of plan liabilities used to determine PBGC premiums for the year of the transfer.

PROPOSAL NO. 4:

Allow transfers from overfunded Section 401(h) accounts to strengthen pension plans and other benefits.

In recent years, many companies have found themselves with very large amounts of surplus assets in their retiree health arrangements, held in either Section 401(h) accounts or VEBAs. In the case of 401(h) accounts, these surpluses are often completely unusable due to legal constraints. So, at a time when there is a great need for funds to pay for pensions or other employee benefits, billions of dollars of surplus assets are being held unusable in 401(h) accounts. **To address this issue, this proposal permits surplus Section 401(h) assets to be used for other benefits under certain conditions that provide security and protection for employees. Because employers would otherwise be deducting the out-of-pocket costs of providing such other benefits, the proposal is expected to raise a material amount of revenue.**

Under the proposal, any "surplus assets" in a 401(h) account would, subject to the protections and safeguards described below, be permitted to be used for other benefits in the following order, without any adverse tax consequences to the employer (i.e., no income tax, no reversion tax, and no additional deduction):

- **For pension benefits under the plan:** The first priority should be to ensure the safety and protection of the retirees and employees benefiting under the pension plan itself. Accordingly, if, as of the most recent valuation date for the plan, the related pension plan portion of the defined benefit plan is less than 110% funded (as determined under Code section 436(j)), but without interest rate stabilization), all surplus assets (as defined below) in the 401(h) account are first transferred to the defined benefit plan to the extent needed to attain such 110% funding. Of course, additional amounts of 401(h) surplus can be transferred to the defined benefit plan over the 110% level to make the plan even more secure.

- **For welfare benefits for active or retired employees (other than key employees):** Here are the safeguards and protections that would apply to the use of the 401(h) surplus for other benefits:

- **Definition of surplus assets:** Surplus 401(h) account assets would be defined as assets in excess of 125% of the present value of the benefits owed under the retiree health plan to which the 401(h) account relates, determined in accordance with applicable accounting standards, after taking into account all other funding with respect to such plan.

    - **Special rules to protect against creating surplus:** For purposes of determining the amount of surplus:

        - *Amounts attributable to 401(h) account contributions (which would not include section 420 transfers) after August 31, 2022 are disregarded.* An employer should not be able to make future contributions to the 401(h) account that create or increase a surplus and then use those previously deducted assets to, for example, pay for active employee medical benefits in later years.

        - *Reductions in benefits after August 31, 2022 are disregarded.* An employer should not be able to cut post-retirement health benefits in the future to create or increase a surplus that can be used for other purposes.

    - **Special rule for terminating pension plans:** If the pension plan is terminating with sufficient assets to pay all pension liabilities, then all assets in the 401(h) account not transferred to the defined benefit plan would be required to be transferred to a VEBA to pay for welfare benefits for active and/or retired employees (other than key employees) and their spouses and eligible dependents.

- **Assets must be held in trust:** To the extent that the surplus is not transferred to the pension portion of the defined benefit plan, such surplus must be kept in the 401(h) account to pay for benefits, as described above, or transferred to a VEBA dedicated to paying permissible VEBA benefits.

- **Defined benefit plan retirement benefits must become vested:** As in the case of transfers under Section 420, pension benefits must be vested in connection with any transfer from a 401(h) account or any use of surplus 401(h) assets for other purposes.

- **Maintenance of effort:** As under Section 420, any welfare plan for which surplus assets are used must not reduce employer cost for five years (or alternatively must not reduce employer-provided benefits for five years).

- **Facilitate use of this proposal to provide benefits to participants.** To facilitate the use of this proposal to provide benefits to participants, one conforming change would be made to Section 420. Under this conforming change, transfers described in Section 420(e)(7) shall be exempt from the limit in Section 420((b)(3) and from the requirement that they be used to pay for retiree liabilities to the extent that such transfers (1) create surplus assets in a 401(h) account, and (2) are used to pay for other benefits under this proposal. In such a case, the maintenance of effort provision under this proposal shall apply in lieu of the maintenance of effort provisions under current law.

PROPOSAL NO. 5

Reduce volatility in the funding rules and protect participants from unfair restrictions on their benefits.

- **Protect participants from benefit restrictions caused by volatile markets or interest rates:** If a plan falls below certain funding thresholds (generally 80% or 60%), plan benefits are restricted in certain ways. For example, if a plan falls below 80% funded, a participant who has been promised the option of taking her benefits in a lump sum, may only receive at most 50% of her benefit in a lump sum. With interest rate and market volatility, well-funded plans can fall below 80% funded, triggering a sudden loss of promised benefits unless the employer can quickly contribute enough to achieve an 80% funded level, which can be prohibitively expensive.
    - **Solution:** Require that the 80% threshold for paying lump sums is only triggered if the plan is below 80% in the current year and at least one of the two preceding two years. This would prevent sudden interest rate or market volatility from immediately triggering harm to participants.
- **Protect plans and participants from market volatility:** For funding purposes, plans are permitted to use the actuarial value of plan assets instead of using the fair market value of assets. Prior to the Pension Protection Act of 2006 (PPA), unexpected gains or losses with respect to plan assets could be recognized over five years for purposes of determining the actuarial value of assets, as long as the actuarial value of assets was within 20% of fair market value. PPA reduced the five-year period to three years and required the actuarial value of assets to be within 10% of fair market value.
    - **Solution:** Return the law to the pre-PPA rule. As noted by the Advocate, one of the key factors driving employers out of the defined benefit plan system is funding volatility.

- **Example**: Assume that a plan was 87% funded for 2021, with $115 million of liabilities and $100 million of assets. Assume further the that the plan was generally invested in large cap equities in 2022 and lost 20% in 2022.[16] So, disregarding expenses, contributions, and benefit payments for simplicity of presentation, the plan's assets started at $100 million and fell to $80 million by the end of 2022. Assume further that the plan's liabilities stayed constant at $115 million. Under current law, the plan's actuarial value of assets would be $88 million (within 10% of fair market value), triggering an immediate additional funding shortfall of $12 million. **Also, this reduction in assets would make the plan 76.5% funded, triggering benefit restrictions, as noted above.**

  Under pre-PPA law, the unexpected loss – which could be $25 million ($20 million plus the failure to gain an expected 5%) – would be spread over five years, so only $5 million of loss would be recognized in 2023, leaving the actuarial value of assets at $95 million (within 20% of fair market value), triggering a more manageable surprise additional funding shortfall of $5 million. (Obviously, the $25 million loss would be fully recognized over five years.) **Also, this reduction in assets to $95 million keeps the plan funded over 80%, thus avoiding benefit restrictions.**

- **Further protect plans and participants from interest rate volatility:** Recent changes in the law have done much to protect plans and participants from volatility attributable to interest rate fluctuations. But one key issue was not addressed. Code Section 430(h)(2) allows plan sponsors to value pension liabilities based on either (1) interest rates averaged over certain periods of time, or (2) spot interest rates. If a plan uses averaged interest rates, it can switch to spot rates at any time. If, however, a plan uses spot interest rates, it cannot switch to averaged interest rates without the approval of the IRS. It hardly seems fair or appropriate to lock a plan sponsor into volatile spot interest rates indefinitely.

  - **Solution:** Permit plan sponsors to elect either spot rates or averaged rates, subject to restrictions on switching back and forth too frequently to game the system (such as no more than three switches in 10 years).

- **Protect participants from losing benefit rights in well-funded plans:** Current law contains a very odd penalty on both (1) employers that make additional unrequired contributions to improve the funded status of their plans, and (2) participants in those plans.

[16] The S&P Index lost 19.44% in 2022.

- **Example:** Assume that a plan has $100 million of liabilities and $80 million of assets. In order to get to 80% funded, the employer contributed $10 million more than what was required, creating a "funding balance" of $10 million (like a prepayment credit that can be used to offset future contribution obligations). In determining whether the plan is at least 80% funded for purposes of the benefit restrictions, the plan is treated as 70% funded because the funding balance is disregarded (unless the employer waives the funding balance) That does not make sense. First, the benefit restrictions are aimed at limiting participant benefits for a plan that is under 80% funded. This plan is not under 80% funded. So, participants lose benefit rights for no reason. Second, this rule discourages employers from making unrequired advance contributions; this is bad policy, since we want to encourage, not discourage, advance contributions.

- **Solution:** In determining whether the benefit restrictions apply, all assets of the plan would be taken into account. And all funding balances that had been waived by reason of the benefit restrictions would be permitted to be restored for the first plan year for which this proposal is effective.

PROPOSAL NO. 6

Facilitate a new type of defined benefit plan that could become quite popular

A new type of plan – a type of variable annuity plan – has emerged that combines a traditional defined benefit plan structure with a limitation on employers' risk, which could become quite popular. Basically, the plan is a traditional defined benefit plan that adjusts benefits based to some extent on the return on plan assets. Participants receive protections from benefit reductions based on an asset reserve created in the plan. The reserve is built in multiple ways, including by capping the asset returns passed through to participants. In short, participant benefits vary based on plan asset returns, but benefits are stabilized, so that participants do not experience the full ups and downs of asset fluctuations.

These plans are being maintained today and are being received very well. But there are small technical uncertainties that are hindering their further growth.

- **Issue No. 1:** It is very difficult to immediately adjust benefits in year 2 based on year 1's asset returns, yet this is being required by the IRS in order to approve these plans. So, the first fix would be to permit benefit adjustments based on asset returns in a year ("asset year") to be made in the second year following the asset year.

- **Issue No. 2:** The current regulations do not provide guidance regarding how to calculate a lump sum benefit for plans of this type. The second fix would be to direct Treasury to, within one year of enactment, specify how lump sums are to be calculated in this type of plan.

- **Issue No. 3:** As noted, in order to protect participants from benefit losses, the plan creates an asset reserve. Using this reserve to protect benefits requires a plan amendment, which could happen several years in a row if the market has a difficult stretch. Under current law, if a benefit amendment is made repeatedly, it might be treated as a right to which participants are entitled. This would not be workable because the reserve could run low. Thus, the current rules discourage employers from using the reserve too often, which hurts participants. So, the third fix would be to provide that amendments to use the reserve do not create rights to future such amendments.

PROPOSAL NO. 7

Update accounting rules for cash-balance plans

There is increasing interest in market-based cash balance plans under which, for example, interest credits on the notional account balance could be based on the return on plan assets (subject to the capital preservation rule). Unfortunately, the current accounting rules treat such plans in a way that is both inaccurate and generally adverse for the plan sponsor. The accounting rules determine the projected benefit obligation (PBO) by projecting forward to normal retirement age at a reasonable projection of the return on plan assets. Then, that projected value is discounted back at the discount rate required under the accounting rules, which can be materially lower than the projected earnings on plan assets. The result of this projection forward at one rate and discounting back at a lower rate creates a type of accounting whipsaw under which the PBO can be materially higher than the sum of the notional account balances. This does not reflect the economic value of the liability.

To address this current inaccuracy, the accounting rules should be updated to provide that either (1) the projected rate is the same as the discount rate, or (2) the PBO equals the sum of the notional accounts. Either approach would need to be supplemented with certain adjustments, such as in the case of annuity payments from the cash balance plan.

PROPOSAL NO. 8

Eliminate a penalty on employers that provide more generous benefits

ERISA Section 205(g) and Code Section 417(e) provide a ceiling on the interest rates that can be used to value distributions, such as lump sum distributions. In determining these interest rates, employers are permitted to use a "lookback month" that is up to five months before the beginning of the year. Generally, the anti-cutback rules prohibit changing the lookback month, but if the employer uses the highest interest rates permitted (the least favorable for employees), a special rule permits a change in the lookback month if for the next year the plan compares the new and old lookback month and uses the more generous interest rates.

Although the law provides a ceiling on interest rates, employers are permitted to establish lower interest rates that provide larger lump sums to participants. Under current law, these employers are not permitted to change their lookback month, for no apparent policy reason. Some such employers would like to change to an earlier month, so that employees have more advance notice of changes in their lump sum value.

Under this proposal, the option to change the lookback month would be permitted for plans using interest rates that are more generous than required by law, as long as the amendment has a delayed effective date of at least one year, so as to protect participants from sudden changes. After any such change in the lookback month, the lookback month may not be changed again for five years without IRS consent. This proposal would not affect plans that use the full 417(e) interest rates, since present law already addresses those plans.

This proposal was in Section 402 of the Retirement Security and Savings Act of 2021 (S. 1770 in the 117th Congress, sponsored by Senator Ben Cardin (D-MD) and then-Senator Rob Portman (R-OH))[17], and in Section 402 of the Retirement Plan Simplification and Enhancement Act of 2017 (H.R. 4524 in the 115th Congress, sponsored by Representative Richard Neal (D-MA)).[18]

ADDITIONAL PROPOSALS

The Council has developed a number of other proposals to streamline defined benefit plan administration and make the rules fairer for non-highly compensated employees. We look forward to sharing these additional proposals as the process moves forward.

[17] https://www.congress.gov/bill/117th-congress/senate-bill/1770

[18] https://www.congress.gov/bill/115th-congress/house-bill/4524