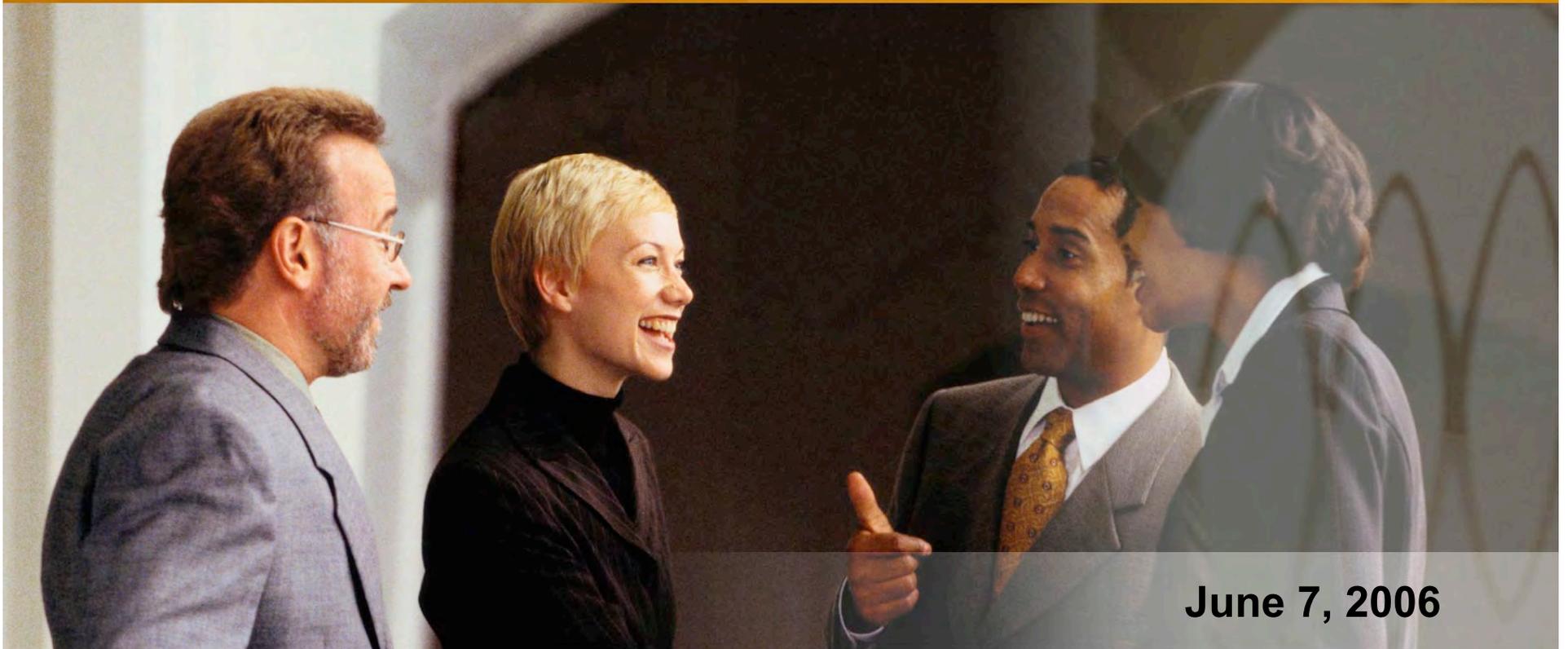


Milliman Client WebEx

- I. Reducing Retirement Plan Benefits
- II. Washington Update



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Agenda

Reducing Retirement Plan Benefits:

An Operating Guide to the Unkindest Cut

Dawilla Madsen, CLU, APM

Dominick Pizzano, CEBS

Washington Update

Rhonda Migdail, JD

Moderator

John Ehrhardt, FSA, MAAA, EA

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CAVEAT

Since Milliman cannot and does not intend to practice law, the information contained on these slides and discussed by the presenters is based on our understanding of applicable laws and should not be construed as legal advice. If a legal opinion is desired on any of the topics discussed during this presentation, the service of your attorney should be sought.



Reducing Retirement Plan Benefits: An Operating Guide to the Unkindest Cut



Introduction

- Why does it seem to be more and more common to consider benefit cuts?
- Reasons may be in response to
 - Dangerously elevated cost levels
 - Redundant benefits
 - Competitive forces
 - Or for cosmetic reasons
- Cutting benefits in a qualified retirement plan can be viewed as analogous to surgery



Introduction

An employer that “scrubs in” as a qualified plan sponsor needs to be aware that the IRS and DOL prohibit them from recklessly hacking away.



Pre-op Considerations

- Removal of vital benefits may cause complications
- The more radical the benefit reduction, the greater the need for an infusion of new benefits to avoid losing the participants



Gray's Anatomy of the Plan

While the dividing line is sometimes more *blurred* than **bright**, the IRS regulations separate the body of the plan into two groups:

- **Protected benefits**
- **Nonprotected benefits**



Gray's Anatomy of the Plan

Protected benefits are a plan's vital organs and are generally resistant to reduction to the extent participants have accrued the benefits.



Gray's Anatomy of the Plan

The IRS rules identify four protected areas:

- Retirement-type benefits
- Early Retirement benefits
- Optional forms of benefits
- Retirement-type subsidies



Gray's Anatomy of the Plan

Retirement-type benefits

- The amount of the accrued benefit
- The method for calculating the amount
- The participant's right to receive benefits on a certain date



Gray's Anatomy of the Plan

Early retirement-type benefits

- The right to commence receiving a retirement-type benefit after severance from employment but before normal retirement age



Gray's Anatomy of the Plan

Optional forms of benefit

- Payments available under plan that differ as a result of
 - Form
 - Timing
 - Commencement
 - Medium of distribution



Gray's Anatomy of the Plan

Retirement-type subsidies

- When the actuarial value of a retirement-type benefit is greater than the actuarial value of the accrued benefit payable at the plan's normal retirement



Can Protected Benefits Be Cut Without Killing the Plan?

Generally - “NO”

- Exceptions:
 - Future benefits
 - Statutory cutbacks
 - Distribution options
 - Other defined benefit plan optional forms



Can Protected Benefits Be Cut Without Killing the Plan?

Statutory cutbacks

- Required by change in law
- IRS will issue guidance on the amendment procedure



Can Protected Benefits Be Cut Without Killing the Plan?

Distribution options

- Joint-and-survivor annuity options
 - All options must be actuarially equivalent to each other
 - Options with the smallest and largest survivor percentages must be retained



Can Protected Benefits Be Cut Without Killing the Plan?

Distribution options in a defined contribution plan

- Lump-sum distribution must be available at the same time and under the same terms as the optional form being eliminated
- Joint and survivor option cannot be eliminated in a money purchase plan
- Noncash medium of distribution may be eliminated



Can Protected Benefits Be Cut Without Killing the Plan?

Distribution options

- Plans may also be amended to permit:
 - A *de minimis* change in the timing (i.e., 2 months for a distribution upon termination and 6 months for an in-service withdrawal)
 - Modifications or the elimination of hardship withdrawal provisions
 - A reduction or elimination of the amount of a mandatory cash-out



Can Protected Benefits Be Cut Without Killing the Plan?

Other defined benefit plan optional forms

- New rules permit elimination under certain circumstances
 - Redundancy alternative
 - Core option alternative
 - De minimis value alternative



Can Protected Benefits Be Cut Without Killing the Plan?

Redundancy alternative

- Optional forms of benefit that are redundant may be eliminated
- Effective as of a date that is at least 90 days after the date the amendment is adopted



Can Protected Benefits Be Cut Without Killing the Plan?

Core option alternative

- Any optional form of benefit that is not a core option may be eliminated
- Effective as of a date that is at least four years after the date the amendment is adopted



Can Protected Benefits Be Cut Without Killing the Plan?

Core option alternative

- Straight life annuity
- 75% J&SA (or both a 50% and 100% J&SA in lieu of the 75% option)
- 10-year certain and life annuity
- The most valuable option for a participant with a short life expectancy (usually a subsidized J&SA or a lump-sum option)



Can Protected Benefits Be Cut Without Killing the Plan?

De minimis value alternative

- May eliminate or reduce benefits (even early retirement benefit or retirement-type subsidies) that create significant burdens and complexities for the plan and its participants
- Must not not adversely affect the rights of any participant in more than a *de minimis* manner



Good News!

Proposed regulations, which are slated to be effective in 2007, allow plans to be amended under certain circumstances to eliminate optional forms (other than core forms) that have not been elected or utilized in a look-back period of generally two years.



Benefits That Are NOT Protected

Ancillary benefits and certain other rights and features are more like cosmetic surgery: as much as participants may enjoy the benefits derived, they are not essential and thus excludable.



Benefits That Are NOT Protected

Ancillary benefits

- Certain disability benefits
- Certain death benefits
- Certain plant shutdown benefits or other similar benefits



Benefits That Are NOT Protected

Ancillary benefits

- Social Security supplements under DB plans
- Life, accident, or health insurance benefits



Benefits That Are NOT Protected

Other rights and features

- Plan loans
- Certain other rights
 - The right to make after-tax or matching contributions
 - The right to direct investments
 - The right to a particular form of investment



Benefits That Are NOT Protected

Other rights and features – continued

- Specified Dates
 - Designated for valuation
 - The allocation of contributions, forfeitures, and earnings
 - The time for making contributions



Benefits That Are NOT Protected

Other rights and features – continued

- Administrative and operational procedures
 - Provisions relating to the particular dates on which notices are given and by which elections must be made
 - Mechanical procedures for allocating investment experience among accounts in DC plans



Benefits That Are NOT Protected

In addition, **future** protected benefits that participants have not yet accrued are not protected from cutbacks.



Benefits That Are NOT Protected

Reduction of future benefits

- In a DC plan
 - Can only apply to that portion of the participant's account balance attributable to contributions made on or after the date the amendment is adopted



Benefits That Are NOT Protected

Reduction of future benefits

- In a DB plan
 - Must grandfather existing benefit
 - Grandfathered benefit will not only include the participant's accrued benefit calculated as of the date of the amendment's adoption, but also the associated actuarial equivalencies and optional forms



Proper Bedside Manner

To reduce or eliminate any benefit (i.e., protected or not), participants must be properly notified.



Proper Bedside Manner

Material Modifications

- Requires a Summary of Material Modification (SMM) to be distributed to plan participants not less than 210 days following the end of the plan year in which the amendment is effective
- Proper bedside manner probably dictates an earlier notification date to soften the blow of the reduction in benefits



Proper Bedside Manner

Significant reductions to DB plans and money purchase DC plans

- Additional requirements apply for a significant reduction in
 - The rate of future benefit accrual
 - An early retirement benefit
 - Or a retirement-type subsidy



Proper Bedside Manner

Significant reductions to DB plans and money purchase DC plans

- Must provide a notice
 - At least 45 days (15 days for plans with fewer than 100 participants) in advance of the plan amendment
 - To participants and alternate payees whose future benefit accrual rates "may reasonably be expected to be significantly reduced" by the amendment and to any employee organizations representing them



Proper Bedside Manner

Significant reductions to DB plans and money purchase DC plans

- Notice must be written so that it can be understood by the average plan participant
- Provide enough information so that the affected individual can grasp the magnitude of the reduction
- Satisfied if at least one illustrative example is provided in the notice



Proper Bedside Manner

Significant reductions to DB plans and money purchase DC plans

- If a notice is required but not provided, \$100 per person per day excise tax until the notice is provided
- If failure to satisfy the notice requirements is intentional, accrual of benefits continued under the provisions prior to the amendment



Infusion Options

Radical benefit reductions

- For example, freezing a DB pension plan
- May leave the morale of employees in critical condition



Infusion Options

Radical benefit reductions

- Reduction procedure may be accompanied by a simultaneous influx of some new benefits
- Communicated at the same time (perhaps even as part of the notice)



Infusion Options

Replacement benefits

- Replacement benefits (such as those provided under a DC plan) might not be as valuable as the original DB plan benefit for some employees
- Can often help in the morale restoration process – especially with younger employees who will have longer periods to accumulate DC amounts before retirement



Infusion Options

Replacement benefits

- Loss of a DB plan will have a much more deleterious effect on employees closer to retirement age since their employment will most likely not survive the extended recovery period necessary for DC accumulations to produce healthy results



Infusion Options

Replacement benefits

- Riskier implant procedures that attempt to stabilize the weakened benefit condition of this group
 - Age-weighted benefit allocations in a DC plan
 - Executive-only nonqualified DB plans that restore lost qualified benefits but must remain at risk (i.e., subject to the creditors of the plan sponsor in the event of insolvency)



Closing Up...

While the final decision never is nor should be easy, employers often find themselves facing a prognosis that presents them with a multitude of valid reasons for cutting benefits.



Closing Up...

The reductions must be planned with surgical precision well in advance to ensure sufficient prep time for the participants affected by the procedure.



Closing Up...

Even if all the regulatory conditions are met, the reduction may need to be accompanied by an infusion of replacement benefits to sustain employee morale and prevent defection to competitors.



Closing Up...

Accordingly, plan sponsors should not attempt any such procedures without first calling in appropriate benefits specialists for a second opinion.



Your Milliman Consultant Can Help

Your Milliman consultant can help you:

- Assess your goals
- Determine if a reduction in benefits is necessary
- Explain all of the available alternatives and options in more detail
- Make the difficult decisions
- Design the most cost effective and beneficial replacement benefits, if applicable
- Communicate your decisions to your employees in the most effective way
- Meet all of the legal amendment and reporting requirements
- With ongoing benefit and asset administration for both frozen and ongoing plans



QUESTIONS ?



Washington Update



Topics

- Legislative Update
- DOE Reimbursement Policy
- IRS Revenue Procedure 2006-27,
Employee Plans Compliance Resolution
System (EPCRS)



Legislative Update



Legislative Update

- Pension reform
- “Small business”/association health plans
- Immigration reform
- Massachusetts healthcare reform plan



Pension Reform



Pension Reform – Major Goals

- Improved funding in defined benefit plans (both single employer and multiemployer)
- Clarify legal status of cash balance plans
- Encourage greater participation in defined contribution plans



Pension Reform

- H.R. 2830, Pension Protection Act –different versions passed by House and Senate
- In “conference” now to iron out differences between the two bills
 - Would then have to be passed by House and Senate again before presented to the President for signature and enactment
- Targeted date for passage was before Memorial Day recess
- Projected date for passage now: before July 4 recess



Pension Reform – Significant Issues

- Single employer plans:
 - Use of credit ratings in determining “at-risk” plans
 - Credit balance issues
 - Transition
- Cash balance/hybrid issues:
 - Prospective versus retroactive relief on age discrimination issue
 - Issue of mandates (e.g., wear-away)
 - Clarification/no inference language



Pension Reform – Significant issues

- Multiemployer plans:
 - Ability to reduce ancillary non-core benefits in “critical” plans
 - Withdrawal liability
- Defined contribution plans:
 - Automatic enrollment
 - Investment advice
- EGTRRA Permanence
- Restrictions on funding nonqualified deferred compensation arrangements



S. 2431, Savings Competitiveness Act of 2006

- Introduced by Senator Max Baucus (D-MT) on March 16
- Employees not covered by qualified retirement plans would be entitled to make contributions to IRAs through payroll deductions
 - Can have automatic enrollment feature
- Employers would need to provide appropriate notice to employees



“Small Business”/ Association Health Plans



Background

- S. 1955, Health Insurance Marketplace Modernization and Affordability Act, was approved by Senate HELP Committee March 14
 - Would allow small business associations to offer fully insured “small business health plans”
- H.R. 525, Small Business Health Fairness Act of 2005, passed by the House July 26, 2005
 - Would permit small businesses to join together to offer “association health plans”



Update

- In May, tried to bring up for debate in Senate, but attempts have been unsuccessful
 - Have been unable to agree to rules to cut off debate
- Even if passed Senate, would then need to go to “conference” with House bill, which is very different in many respects
- Possible, but unlikely, passage this year



Immigration Reform



Employer Verification

- The House and Senate immigration bills (H.R.4437 and S. 2611) each contain a provision that would require employers to use an electronic verification system to confirm workers' employment eligibility
 - H.R. 4437 was passed December 16, 2005 (by a vote of 239-182)
 - Phases in verification system over 6 years
 - Extends the program to cover current (and new) employees



Employer verification

- S. 2611 was passed on May 25 (by a vote of 62-36)
 - Amendment to Senate version provides that the verification system would apply to all employers 18 months after Congress appropriates funds needed to implement system.
- The House and Senate bills will now need to go to “conference”



Massachusetts Health Care Reform Plan



Massachusetts Universal Health Insurance Access

On April 12, Massachusetts Governor Romney signed into law “*An Act Providing Access to Affordable, Quality, Accountable Health Care.*”



Massachusetts Universal Health Insurance Access

- *Individual Mandate*
 - *Requires* all Massachusetts residents to obtain health insurance coverage as of July 1, 2007, except for those for whom affordable products are not available
 - Disclosed on 2008 state income tax returns with financial penalties for failure (i.e., beginning with loss of personal exemption for 2007 tax year)



Massachusetts Universal Health Insurance Access

- *Employer Mandates*
 - “Free rider” surcharge where employees use “free care”
 - Employers with more than 10 employees required to offer cafeteria plan
 - Annual “fair share” assessment of up to \$295 per employee on employers of 11 or more workers that do not provide health insurance and make fair contribution to its cost
 - The Massachusetts Senate and House have overridden Governor Romney’s veto



Massachusetts Universal Health Insurance Access

- Many states are monitoring this and other states' activities in efforts to expand healthcare coverage in an “affordable” manner
- Too early to know whether there may be an ERISA preemption challenge to certain of the statutory requirements



DOE Reimbursement Policy



DOE Reimbursement Policy

- On April 27, 2006, the Department of Energy (DOE) announced a new reimbursement policy for contractor pension and medical benefit plan costs
 - Continue to reimburse costs for current and retired contractor employees' defined benefit pension plans and medical benefit plans under existing contract requirements



DOE Reimbursement Costs

However, for new contractor employees hired after a date no later than March 1, 2007, DOE would only reimburse costs for “market-based” defined contribution pension plans, similar to 401(k) plans and “market-based” medical benefit plans



DOE Reimbursement Costs

- House approved H.R. 5427, FY 2007 appropriations for energy and water development, on May 24, with a prohibition on the Energy Department's use of funds to implement the policy for one year
- Senator Kennedy (D-MA) and Senate Minority Leader Harry Reid (D-NV) have each introduced legislation, S. 2794 and H.R. 5362, that would prohibit the use of funds for this purpose permanently



Revenue Procedure 2006-27, EPCRS



Background - EPCRS

- Employee Plans Compliance Resolution System (EPCRS):
 - Permits plan sponsors to voluntarily correct certain compliance errors without risking plan disqualification or adverse tax consequences
 - Available for certain plan document, operational, demographic, and employer eligibility failures



Background - EPCRS

- Three available programs:
 - Self-Correction Program (SCP)
 - Voluntary Correction with Service Approval Program (VCP)
 - Correction on Audit Program (Audit CAP)
- Revenue Procedure 2006-27 expands the types of failures that may be corrected and provides additional correction methods



Revenue Procedure 2006-27

- Now covers certain plan loans that:
 - Exceed the statutory limit
 - Fail to be repaid in accordance with the statutory repayment schedule
 - Are defaulted on
- New methodology for correcting exclusion of eligible employees in a 401(k) plan
- Streamlined VCP procedures for certain non-amenders



Revenue Procedure 2006-27

■ Coverage for:

- Orphan plans
- Terminating plans for qualification failures
- Eligible governmental 457(b) plans on a provisional basis



QUESTIONS ?

