The Pension Protection Act 2006

Reforms to Help Plan Sponsors Manage Retirement Plans More Effectively

BY CHAD GOERNER, CIMA®, CFP®

The Pension Protection Act of 2006 (PPA 2006) is expected to affect many aspects of defined contribution and defined benefit plan management. Upon the signing of PPA 2006 into law in August 2006, U.S. House of Representatives Workforce Committee Chairman Howard McKeon hailed the legislation and said that PPA 2006 “ensures that worker pension plans are fully funded, encourages companies and unions to keep their pension promises to workers and retirees, and provides workers the peace of mind that their retirement savings will be there for them when they need it.”

As many of the provisions of PPA 2006 approach their effective dates, it will be important for both plan sponsors and consultants to understand the key provisions in order to benefit from some of the new rules.

PPA 2006: Defined Contribution Plans Investment Advice

Perhaps one of the most talked-about provisions in PPA 2006 is the one that allows fiduciaries to provide professional investment advice to participants in participant-directed defined contribution plans. Specifically, PPA 2006 provides a statutory exemption for plan sponsors and certain other fiduciaries from the Employee Retirement Income Security Act of 1974 (ERISA) and Internal Revenue Code prohibited transaction rules for advice given to participants, provided certain requirements are met. PPA 2006 permits qualified “fiduciary advisers” to offer an investment advice arrangement to help plan participants manage their retirement savings through either 1) a level-fee structure where compensation does not depend on the investment option selected or 2) a computer-based model that is certified by an independent investment expert.

In the past, many consultants to retirement plan sponsors would have been willing to provide only generic asset allocation advice and education to participants for fear of being considered a fiduciary to the plan. This limitation has contributed to a general sense of confusion for many plan participants when it comes to selecting investment options, understanding specific risks associated with those options, and effectively using lifestyle funds. The lifestyle fund is a unitary investment option that offers diversification among stocks and bonds according to risk tolerance and/or time horizon.

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This lack of understanding is evident in the recent Vanguard defined contribution survey, “How America Saves 2006.” While many plans have continued to offer more and more plan investment options, the average number of investment options utilized by the average participant has been relatively stagnant (see figure 1). This recent Vanguard survey found that about 56 percent of participants used only between one and three investment options (see figure 2). Furthermore, many plans have been making lifestyle-type funds available to their participants over the past several years, but the utilization rate has not been as high as many plan sponsors would desire. According to the same survey, in 2005 67 percent of Vanguard’s plans offered lifestyle-type funds yet only 9 percent of plan assets on average were invested in them. Offering qualified investment advice under PPA 2006 is intended to affect these statistics more positively. For participants, it is hoped that PPA 2006 will result in a better understanding of the benefits of diversification and the plan’s underlying investment options along with its risks and costs—all in an effort to help participants better prepare for retirement.

Automatic Enrollment and Default Investment Options

Even before PPA 2006 was enacted, many plan sponsors had considered implementing automatic enrollment to both encourage participants’ retirement savings and improve their nondiscrimination testing.
results. PPA 2006 now provides plan sponsors with guidance on implementation of automatic enrollment programs and makes it available for all states because the act preempts conflicting state law. Some states previously considered automatic enrollment of employees by employers a garnishment of wages and did not allow it. To accompany automatic enrollment, PPA 2006 makes default investment options (e.g., lifestyle funds, age-based and/or risk-based) a more viable option than having automatically enrolled employees defer into the money market or stable value option. It does so by protecting a plan sponsor’s decision to use a default option under ERISA 404(c), as long as the plan sponsor meets certain annual notice requirements. The notice must include an explanation of employees’ ability to direct their own investments and outline how their accounts will be invested if they do not elect their own investment option(s). Plan fiduciaries will continue to be liable for prudently selecting and monitoring the default investment options.

Automatic Enrollment Safe Harbor
With the anticipated increase in automatic enrollment programs, an additional nondiscrimination safe harbor provision has been added (available for plan years after December 31, 2007). The new provision allows for a vesting schedule (albeit with a two-year maximum), and an automatic increase in the default savings rate under the automatic enrollment, where the participant’s default deferral rate must be at least 3 percent the first year and rise by 1 percent per year until the fourth year where it would rise to 6 percent, allowing the employer to set a maximum of 10 percent.

Under PPA 2006, the matching contribution requirement for the safe harbor is that an employer is required to match 100 percent of the first 1 percent of compensation and 50 percent of the next 5 percent. Alternatively, the employer can choose to make a 3-percent nonelective contribution.

Portability and Distribution Flexibility
PPA 2006 also made permanent many of the provisions of the Economic Growth and Tax Reconciliation Relief Act (EGTRRA) related to the portability and distribution of retirement assets, and added some entirely new provisions as well. Some of the key benefits are as follows:

- PPA 2006 makes permanent the EGTRRA portability rules that allow after-tax amounts to be directly rolled over between different qualified plan types; for example, from a 401(k) plan to a 403(b) plan as opposed to just similar plan types (e.g., 401(k) to 401(k)).
- Beginning in 2008, PPA 2006 streamlines Roth IRA conversions by allowing a direct rollover from a qualified plan. Ordinary income taxes will, of course, still be due on the amount rolled over and the $100,000 modified adjusted gross income eligibility requirement still will apply, but it is not subject to a 10-percent penalty and it is not subject to mandatory withholding.
- In the event of a participant’s death, previous rules allowed only a spouse beneficiary to perform a direct rollover of inherited assets to the spouse’s IRA. PPA 2006 now allows nonspouse beneficiaries to roll over assets to an inherited IRA. Nonspouse beneficiaries can’t contribute to the inherited IRAs, and they will have to take an annual minimum distribution.
(based on their own life expectan-
ties), however the remaining assets can continue to grow tax-
deferred. Previously many non-
spouse beneficiaries were forced to take a taxable distribution of the assets they inherited from an employer plan.

- Hardship distributions also are expanded to allow for distribu-
tions due to financial emergencies of the participant’s dependents and/or spouse.

Applying PPA 2006 to the Plan Sponsor: Defined Contribution Plans

PPA 2006 provides new opportuni-
ties to existing defined contribution plans as they increasingly become the main retirement savings vehicle for many U.S. employees. With a personal savings rate that has been negative for the past two years according to the Bureau of Economic Analysis (www.bea.gov), most Americans may be unprepared for retirement. PPA 2006 empowers plan sponsors to help participants increase their account balances through automatic enrollment, default lifestyle fund options, and investment advice to help them better prepare for retirement.

For plan sponsors and their con-
sultants, the management of defined contribution plans is expected to change and some of the following new opportunities should be actively considered.

- **Plan Design.** Incorporating new automatic enrollment, safe harbor, default investment options, and investment advice for participants (see figure 3).

- **Investment Options.** Lifestyle funds now are offered in many plans, however utilization rates are not as robust as many plan sponsors would like them to be and in many cases they are not being utilized effectively by participants as shown in figure 4. The consultant now has the ability to recommend imple-
mentation of default lifestyle investment options, some of which are customized by the participant’s age.

As participant level investment advice becomes more prevalent as a result of PPA 2006, active monitoring of all investment options by plan fiduciaries will be critical.

- **Education and Communication Programs.** PPA 2006 will bring many new education and communication needs for plan sponsors. Plan sponsors undoubtedly will look to inform participants about any newly added plan provisions such as automatic enrollment and the implications of a default lifestyle option. Also, while many plans may rely on Web-based investment advice, the utilization by plan participants of such advice typically has been low. A Greenwich Associates survey of 928 mid-sized U.S. corporations found only 35 per-
cent of defined contribution plan participants use Web-based tools. Instead, effective education likely will spring from the personalized, one-on-one education programs that the consultant can develop for the plan that will determine its long-term success.

PPA 2006: Defined Benefit Plans

Minimum Required Contributions

Previous regulations gave plan spon-
sors a funding target of 90 percent. Beginning in 2008, PPA 2006 will require the funding target to increase to 100 percent and change from using a range of amortization periods for unfunded liabilities to a seven-year amortization period. The shortfall amortization rule changes made by PPA 2006 will be subject to a transition rule for plan years beginning after 2007 and before

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**FIGURE 3** Likely Enhancements in 401(k) and 403(b) Plans under PPA 2006

<table>
<thead>
<tr>
<th>Likely Enhancements</th>
<th>Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduce annuity distribution options</td>
<td>11%</td>
</tr>
<tr>
<td>Change investment options to allow greater diversification</td>
<td>18%</td>
</tr>
<tr>
<td>Increase nonelective contributions or company match</td>
<td>10%</td>
</tr>
<tr>
<td>Introduce automatic enrollment</td>
<td>42%</td>
</tr>
<tr>
<td>Provide more investment advice to participants</td>
<td>46%</td>
</tr>
</tbody>
</table>

2011. According to Merrill Lynch, “the maximum required funding for any plan year would be the sum of (1) the plan’s normal cost for the plan year and (2) the ‘shortfall contribution’ necessary to amortize over seven years the difference between plan assets and 100% of the present value of future liabilities over seven years.” According to a TowersPerrin survey, this new funding system has many plan sponsors expecting higher contributions (see figure 5).

**At-Risk Plans**

Plans generally will be considered “at-risk” for a plan year if they have a “funding target attainment percentage” for the preceding plan year of less than 80 percent and less than 70 percent when computed using the at-risk plan actuarial assumptions. At-risk plans generally will face higher contribution amounts and higher PBGC premiums to reflect the risk that they place on the system.

PPA 2006 also places a number of restrictions on lump-sum distributions for at-risk plans. For example, plans that have an “adjusted funding target attainment percentage” of at least 60 percent and less than 80 percent generally can pay only 50 percent of the participant’s benefit as a lump sum, and plans below 60 percent are allowed to utilize only a single life annuity payment (including certain adjustments for Social Security).

**Hybrid Plans—Cash Balance and Pension Equity Plans**

Historically there has been uncertainty about the viability of cash balance and pension equity plans because of accusations that the plans caused age discrimination in favor of younger employees. PPA 2006 effectively ends that debate and makes cash balance plans a viable alternate plan structure by establishing an age discrimination standard for applicable defined benefit plans. The standard is satisfied if the participant’s accrued benefit at any time is equal to or greater than that of a similarly situated younger individual in a comparable traditional defined benefit, cash balance, or pension equity plan.

With this determination, cash balance and pension equity plans become true alternatives to the traditional defined benefit plan structure. Cash balance plans, to refresh the reader’s memory, provide a participant with a hypothetical pay credit (i.e., a percentage of compensation) and an interest credit (a fixed- or variable-rate credit...
linked to an index). The risk is borne by the employer in guaranteeing the rate of return. Pension equity plans differ from cash balance plans in terms of how benefits are accumulated. Table 1 from the U.S. Department of Labor spells out some of the key differences.

**Defined Benefit/401(k) Plans for Small- to Medium-sized Employers**

PPA 2006 creates a combined 401(k)/defined benefit plan structure for employers with 500 or fewer employees. On the defined benefit side, the employer needs to provide a minimum benefit not less than the applicable percentage as provided under PPA 2006 to each eligible participant. This benefit also must be fully vested after a three-year period. For the defined contribution or 401(k) portion, the employer must provide matching contributions with at least a match of 50 percent up to 4 percent of the participant’s compensation deferred into the plan.

This plan structure may be attractive for employers because the combined plan will be exempt from top-heavy rules and will be exempt from actual deferral percentage/actual contribution percentage (ADP/ACP) testing (effectively a safe harbor). It also may benefit from lower administrative costs because it allows one Form 5500 filing, one trust, and a single plan document.

**Applying PPA 2006 to the Plan Sponsor: Defined Benefit Plans**

The new funding requirements implemented under PPA 2006 should focus consultants and plan sponsors to proactively manage plan assets by matching plan assets

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**TABLE 1 Key Differences between Pension Equity and Cash Balance Plans**

<table>
<thead>
<tr>
<th>FEATURE</th>
<th>PENSION EQUITY PLAN</th>
<th>CASH BALANCE PLAN</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BENEFIT FORMULA</strong></td>
<td>Percent of earnings, may vary by age, service, or earnings</td>
<td>Percent of earnings, may vary by age, service, or earnings</td>
</tr>
<tr>
<td><strong>HOW BENEFITS ARE ACCUMULATED</strong></td>
<td>Percent of earnings, as determined by the benefit formula, are accumulated each year, but the final benefit is not determined until employee leaves the plan</td>
<td>Dollar amount (benefit formula times earnings) placed in a hypothetical account each year; interest on account balance also credited each year</td>
</tr>
<tr>
<td><strong>DEFINITION OF EARNINGS</strong></td>
<td>Total accumulated benefit applied to final earnings, as defined by the plan; final earnings typically those in last 3–5 years before retirement</td>
<td>Percent applied to each year’s earnings</td>
</tr>
<tr>
<td><strong>HOW TO DETERMINE VALUE OF BENEFITS FOR CURRENT EMPLOYEES</strong></td>
<td>Employees can multiply their accumulated percent of earnings times their final earnings as defined by the plan to determine their current benefit</td>
<td>Account balance is current benefit</td>
</tr>
<tr>
<td><strong>DISTRIBUTIONS</strong></td>
<td>Specified as a lump sum but can be converted to an annuity</td>
<td>Specified as a lump sum but can be converted to an annuity</td>
</tr>
</tbody>
</table>

Source: U.S. Department of Labor

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**FIGURE 6 Likelihood of Putting More Emphasis on Bonds**

- **Very Likely:** 8%
- **Somewhat Likely:** 24%
- **Not Very/Not at All Likely:** 31%
- **Don’t Know:** 37%


**FIGURE 7 Likelihood of Putting More Emphasis on Derivatives, Overlays, and Similar Instruments**

- **Very Likely:** 5%
- **Somewhat Likely:** 20%
- **Not Very/Not at All Likely:** 42%
- **Don’t Know:** 33%

to liabilities. One way to accomplish this is to match the duration of fixed income in the plan to the plan’s liabilities, the use of derivatives, or a combination of the two. This form of investment management, termed liability-driven investing (LDI), essentially has been recognized by the Department of Labor (DOL). In a recent advisory opinion the DOL stated that a plan fiduciary could “consider the liability obligations of the plan and the risks associated with such liability obligations in determining a prudent investment strategy for the plan.” Figures 6 and 7, from the TowersPerrin survey, show that many plan sponsors actively are considering LDI as a result of PPA 2006’s passage.

PPA 2006 may also result in hybrid cash balance and pension equity plans being adopted by plan sponsors eager to create a more predictable funding structure and at the same time provide for a guaranteed benefit for a more mobile workforce.

The combination defined benefit/401(k) plan for small- and medium-sized employers will allow companies to provide a pension benefit with a 401(k) capability at a reasonable cost and with streamlined administration.

Summary
The Pension Protection Act of 2006 has resulted in many changes to both the defined contribution and defined benefit plan arenas. For defined contribution plans, it provides tools to help plan sponsors encourage more employees to save for retirement and the advice to help them understand how to accomplish their retirement goals more effectively. For defined benefit plans, it strengthens the system with safeguards to provide increased pension security and transparency and offers additional plan structures that provide employers with more flexibility in providing retirement benefits to employees. By gaining a thorough understanding of the new regulations, plan sponsors and consultants will be able to take advantage of the changes introduced by PPA 2006 to make their retirement plans a more valuable employee benefit for all participants.

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Endnotes
1. House Committee on Education & the Workforce, “President Signs Measure to Reform Outdated Worker Pension Laws,” press release (August 17, 2006).