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Testimony on Cash Balance Plans, Conversions, and Disclosure

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Cash balance pension plans have become popular recently, especially among large employers. One-fourth of Fortune 100 companies now have account balance type formulas, like a cash balance plan. In addition, employees (especially younger ones) like them because it is easy to understand their account balance nature. However, with this increased popularity comes more scrutiny. Newspaper articles have suggested that some employers who converted from a traditional plan to a cash balance plan did so to save money. Moreover, some employers have been accused of not properly informing their older employees about how the conversion to a cash balance plan could reduce their benefits. As a result, Congress is now considering various proposals that would tighten the disclosure requirements for employers who switch to cash balance plans.

The American Academy of Actuaries intends for this testimony to provide an objective discussion of cash balance plans, their pros and cons, the lack of guidance in how laws apply to these new kind of hybrid plans, and ideas for how to address some of the problems that could arise when employers switch from a traditional pension plan to a cash balance plan.

Background on Cash Balance Plans

Cash balance pension plans look like defined contribution (DC) plans because they have hypothetical individual accounts for each participant. However, they really are defined benefit (DB) plans because their benefits are determined by formulas in pension plan documents, not by the assets in one's pension account. Cash balance plans are sometimes included in a category called hybrid plans, because they are DB plans that look like DC plans. Since they are DB plans, they have

flexibility in their design¹ and funding and the benefits are guaranteed by the employer and insured by the Pension Benefit Guaranty Corporation.

An example: A cash balance document defines a pay credit that is added to one's notional account each year (e.g., 4% or 6% of pay). It also defines a yield on the notional account (e.g., the 1-year T-Bill rate plus 1%, or the 30-year Treasury bond rate, or the CPI). Thus, a simple cash balance plan would look like a 6% of pay defined contribution plan that had a return equal to T-Bills plus 1%.²

When the participant in a cash balance plan reaches retirement the account is converted to an annuity at the price specified in the plan. In addition, cash balance plans generally allow participants to take their account balance with them in a lump sum, as long as the employee is vested (typically reached after 5 years of service). Unlike 401(k) accounts, cash balance plans generally do not require employee contributions in order to get the employer contribution. This is an advantage for lower-paid, young, and short service employees who often get little or nothing from their 401(k) plan. As

¹ The flexibility of cash balance plans is constrained a great deal currently by the IRC and IRS because regulators and employers are unsure of how to apply the standard DB rules to cash balance plans.

² The most common interest credits are the 30-year Treasury rate and the 1 year T-Bill rate plus x%, due to suggestions in IRS Notice 96-8 regarding IRC§417(e), which would make it difficult to promise a better rate. Since these rates are around 6% currently, and many people think they can get double digit returns in the stock market, employees may not be happy with this interest credit. However, if the plan promised a higher interest credit (e.g., the Treasury rate +2%, or the average return on some stock index), then it would get "whip-sawed". Lump sum cash outs could be twice the size of the notional account balance for someone under age 30. This is because the IRS Notice suggests that the law requires the lump sum be at least equal to the present value (using the 30-year Treasury rate) of the promised pension (based on the account balance growing at the interest credit rate). One remedy for this would be to for Congress to clarify that if the promise is an account balance and a yield that can be achieved in the markets, that the lump sum could be the amount of the account balance. Some employers subsidize the annuity purchase rate to encourage participants to select annuities, just as some traditional plans subsidize early retirement benefits. One important question for Congress is whether this subsidy should be reflected in the lump sum. If it is, then it would discourage employers from subsidizing annuities - something Congress should want.

much as 50% of these employees do not participate in 401(k) plans, because they could not or did not contribute to the plan.

Assets and Employer Contributions: Like any DB plan, the employer can invest the combined pension assets of all his or her employees anywhere that is prudent, but of course the assets will probably not yield exactly what was promised to the participant in the plan document. If the assets earned *less* than the plan promised, the employer would have to make up the difference. This difference can be made up over several years because of the flexible funding rules for DB plans. In this case, the employer's annual contribution would be larger than the pay credit rate (e.g., the 6% of pay mentioned above). On the other hand, the assets could yield *more* than promised. In this case the annual contribution would be less than the pay credit rate (e.g., the 6% of pay mentioned above).

Risks and Rewards: As discussed above, the employer generally takes on the investment risk, not the employee³, and gets the investment reward if assets do better. This is typical in DB plans. If interest rates go up, the employer suffers any depreciation in the plan's assets (i.e., not the employee), and if interest rates go down, the employer gets the resulting asset appreciation (i.e., not the employee).

Annuity Prices: However, the employer doesn't remove all of the investment risk from the participants. In a traditional DB plan, the plan document promises a pension amount that is not affected by the interest rates (or annuity prices) prevalent at one's retirement. However, DB lump

³ The employer can give the risk and rewards to employees if the plan document provides (or allows employees to elect to get) returns from a market index.

sum amounts are not stable. They vary greatly with the interest rates. On the other hand, *in a cash balance plan the lump sums are stabilized*, but often the annuities are not. If interest rates go down (which means annuity prices go up), then the participant's notional account balance at retirement buys a smaller pension. Since more people in cash balance plans choose to take lump sums over lifetime pensions, more people are getting the stable benefit in the cash balance plan.

The above risk can be moved to the employer by crediting accounts with some appreciation when interest rates go down. Alternatively, about 1/3 of employers take on the above risk by holding the annuity purchase rates constant in the plan (even when insurance company annuity prices increase). However, then the plan could have the same §417(e) whipsaw problem mentioned earlier. This is a shame, because a consistent purchase rate could encourage more employees to elect annuities.

Longevity Risk: Similar to all DB plans, cash balance plans can also retain the longevity risk, or the risk that employees will outlive their pension, if employees select the annuity option.⁴ As in any retirement plan, participants who take lump sums lose this protection, because they might spend their lump sum too fast and run out of money. It must be noted however, that if people started living longer, employers could amend the plan to increase the purchase rates. However, they would have to use the old rate for the prior accruals as a minimum benefit.⁵

⁴ Some cash balance plans require at least some of the account be paid as an annuity.

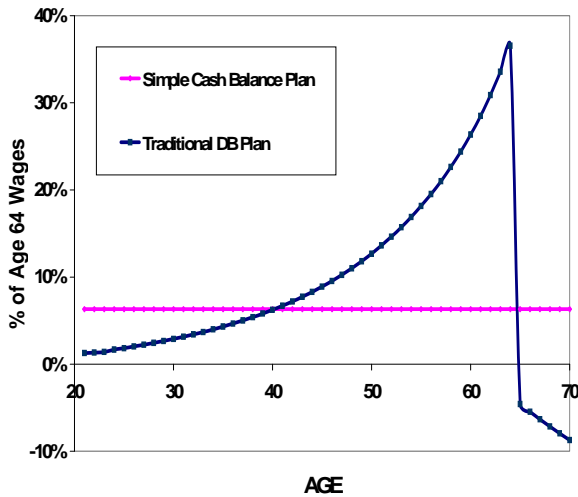
⁵ Note: this is not the same as applying the old annuity purchase rate to the prior accruals and the new annuity purchase rate to future accruals. Eventually the prior plan minimum can wear away, as new accruals increase the total benefit. This can cause a plateau in one's pension for a few years. Alternatively, the plan could avoid the plateau by using the method suggested in the first sentence of this footnote, but then the plan would have to keep the old rules around until all of today's employees retired.

Comparing Accruals with Traditional DB plans: Chart I compares contributions to an individual for the following 2 hypothetical pension plans:

(1) a simple cash balance plan with a flat 6% pay credit and an annual interest credit of 5%, and

(2) a traditional DB plan with an annual benefit at age 65 of 1% times years worked times final pay.

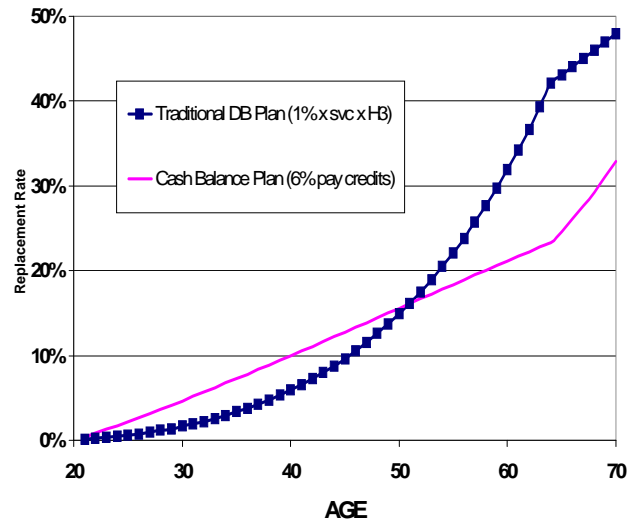
Chart I - Annual Contribution Rates
(assuming UC funding method and 5% interest)



You will note that the cash balance plan has fairly level accruals at all ages. They are much

larger than the accruals of the traditional DB plan for young employees, but are much smaller for older employees. Chart II shows that someone who spent all their working career at a company with the traditional pension plan - number (1) above - will get a larger pension than if in the simple cash balance plan - number (2) above. This is because the cash balance plan spends more of its money on employees who terminate before retirement.

Chart II - Replacement Rates
(as % of wages at age 64)



However, this analysis does not apply to people who change jobs. For employees who work for 2 or more companies with the above traditional DB plan, their benefits could be much smaller than what Chart II shows. On the other hand, for employees who worked for 2 or more companies with the cash balance formula above, their benefit at retirement would still be the same (and thus possibly larger than the traditional benefit). The best of all worlds would be to work for a company with a cash balance plan while young and for a traditional DB plan in your last one or two jobs. Many

baby boomers unfortunately will switch in the opposite direction, as there were few cash balance plans when they were young.

Chart III - Annual Contribution Rates
(assuming UC funding method and 5% interest)

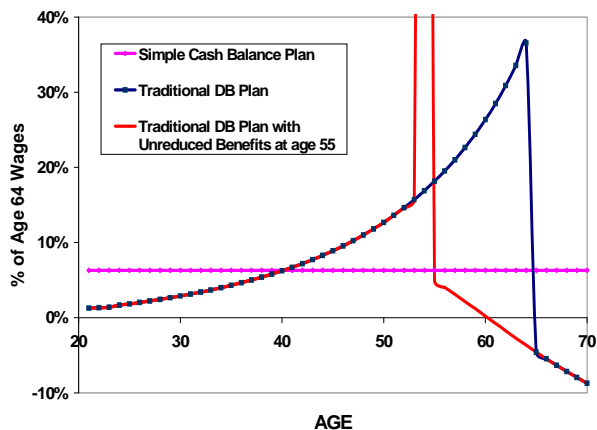


Chart III shows the accrual patterns for a DB plan if it had an unreduced benefit at age 55. The spike at age 55 shows why it would be imprudent for employees in such a plan to quit in their late 40s and 50s (the golden

handcuffs). It also shows why they would be foolish to work after age 55 (the boot). If they want to work more, they might consider retiring from the current company, get the great pension, and find work elsewhere (if possible).

Age-Weighted and Service-Weighted Benefits: Not all cash balance plans provide the same pay credits to all employees. In fact, surveys show that most CB plans allocate larger pay credits to

older and longer-service employees than they do to younger employees.⁶ This is legal as long as the benefits are not impermissibly “back loaded” as defined in Section 411(b) of the IRC. One of these rules requires that benefits purchased at retirement from any one year’s accrual can not be more than 133% of a benefit purchased in an earlier year. For example, the plan might allocate 4% of pay to employees in their 20s and 30s, 5% of pay to employees in their 40s and 50s, and 6% of pay to older employees. This could be legal even though the 6% is more than 133% of 4%, because the 4% accruals earn more interest credits by the time age 65 is reached. As discussed earlier, cash balance plans are generally more front-loaded than the traditional DB plan which is often “back loaded”. This is true even if the cash balance plan has some age-weighting of benefits. Alternatively, some cash balance plans are designed to provide larger pay credits to participants with more service (i.e., “service-weighted” plans and “age- and service-weighted” plans). For example, they could have 4% pay credits for service under 10 years, 5% credits if service is between 10 and 20 years, and 6% above that.

Integration: Like traditional DB plans, many cash balance plans integrate their benefits with Social Security. They do so by providing a larger pay credit for employees with higher income levels to offset the fact that Social Security pays more to people at lower income levels. However, this hurts the simplicity of the typical cash balance plan and can make it more difficult to qualify the plan.

Why Cash Balance plans?

Workforce Management: Some of the reasons that employers have switched to cash balance plans

⁶ In fact, a cash balance plan could be made to mimic the steeply back-loaded benefits from a traditional DB plan.

are related to the above points. Cash balance plans are easier to understand and give larger accruals than traditional plans to younger employees (which helps in hiring and retaining them), they don't keep unhappy employees locked in the job in the years leading up to the first retirement age, and they don't push employees out at older ages⁷. In the past, employers may have wanted to retain employees for longer periods and be able to retire them at age 65 (or earlier, especially in physically-demanding jobs). However, the work world is changing. With the coming retirement of the baby boomer generation and concomitant shrinking of the labor force, many employers are changing their retirement strategies from retiring employees at, for example age 55, to encouraging them to stay (at least part time). Cash balance plans can be a part of this strategy change. Furthermore, if someday the employer needs to downsize the corporation somewhat they can still use the cash balance plan by placing an early retirement window in it for a temporary period focused on encouraging certain older employees to retire just as in the traditional DB plan.

History may provide some other clues: Prior to ERISA, many employers paid pension benefits only to employees who reached their normal retirement age; nothing to earlier separations. However, in 1974, landmark pension legislation (ERISA) forced employers to pay something to employees who separated earlier. The following paragraphs show several responses that led to cash balance plans.

Generous Employers: Some employers recognized that the ERISA minimum still did not provide much for younger participants, so they gave more than the required amount. One way was to give

⁷ Traditional plans do not have unreduced early retirement benefits to push out employees at older ages. In addition, they can provide for accruals after normal retirement age plus actuarial increases.

cost-of-living-increases (COLAs) in their plans even after separation of employment. (Final pay plans automatically update benefits before separation.) However, COLAs were expensive and complex, so COLAs were extremely rare. Bank of America recognized that a cash balance plan would be the same as a traditional career-average DB plan with COLAs (where the COLA equaled the interest credit rate both before and after separation).⁸ The advantages for the cash balance plan was that it was also easier for the employees to understand and appreciate, and it had less risk for the employer (by using an interest rate instead of the inflation rate). So, BofA started the first qualified cash balance plan in the mid-1980's.

Larger benefits for younger employees are expensive: Most employers didn't provide much to younger employees in their traditional DB plans. They assumed (generally correctly) that younger employees were less interested in the retirement plan (partly because the employees didn't understand its worth). These employers primarily wanted their plans to reward their retirees and to help them retire with dignity, thus enabling promotions to younger employees. They could have given more to younger employees, but that would have been expensive. With a fixed budget, that would have meant smaller pensions for older employees. Besides, not many competitors provided better benefits to younger employees either.

Competition from 401(k) plans: With the advent of 401(k) plans around 1980, employers could enable larger accruals for younger employees without having to pay for them. ERISA allowed

⁸ This assumes that the annuity purchase rate in the cash balance plan doesn't change with the interest rate. As explained earlier, cash balance plans (unlike traditional DB plans), don't have to immunize the employee from swings in the costs of annuities, since their primary promise at retirement is an account balance, not a pension. They can let the annuity purchase rate change with the interest rate.

employees to pay for them with pre-tax dollars if done in a profit-sharing plan. With the stock market performing so well, many employees liked these 401(k) plans better than the traditional DB plans even though it was the employees who paid for most of the contributions (sometimes all of them) and assumed all of the investment risk. Therefore, many employers switched to 401(k) plans⁹, especially smaller employers. However, experience shows that less than one-half of low-paid employees participate in their 401(k) plans. Many employers, recognizing this concern, used the 401(k) as a *supplemental* retirement plan (not a *replacement* plan) and reduced their expensive traditional DB plan, sometimes converting it to a cash balance plan. The cost of the cash balance plan plus the cost of the 401(k) might be close the cost of their old traditional plan, but it would be more focused on younger employees.

Level Playing Field: If DB plans could also have 401(k) pretax employee contributions and 401(m) matching features, that might have slowed this exodus. However, now we have a situation where the number of DB plans has dropped over 60% and the amount of money flowing into 401(k) plans exceeds the amount flowing into DB plans. Clarifying and simplifying the complex rules that apply to DB plans, especially cash balance plans, could also stem this tide. However, we should ask why we would want to do that. What features do cash balance plans have that we want to preserve? And, do they outweigh the disadvantages that have recently been brought to the public's attention?

⁹ Replacing a DB plan with a 401(k) now is not easy. If the DB plan being replaced is *overfunded*, any reversion would be subject to an income tax of about 35% and an excise tax of 20%. Thus, about 55% of the reversion would be lost, which employers would want to avoid. On the other hand, if the DB plan is *underfunded* prior to replacement, the employer would have to immediately come up with a large amount of cash in order to move forward. This is another reason many employers switched to cash balance plans. It had less problems with the surplus or underfunding.

Advantages of Cash Balance Plans to Employees

- (1) Cash Balance plans are easier for employees to understand and appreciate than traditional DB plans. For example, prospective employees can easily add the annual pay credit to their wage offer, and they can understand how the *value* of their pension grows over time. Employees often don't know how to determine the *value* of a deferred annuity that traditional DB plans offer (especially since the value changes with interest rates).
- (2) Cash balance plans generally provide larger benefit accruals at younger ages than traditional DB plans. This makes it easier for employees to change jobs and not lose out on their pension. It supports, rather than hinders, a dynamic mobile workforce and is especially helpful to women who often leaving the workforce to care for the family.
- (3) Cash balance plans, unlike traditional DB plans, are not so expensive at older ages that they discourage the hiring of older employees.
- (4) Defined contribution plans and 401(k) features have the above advantages also, so why not use them? Well, cash balance (CB) plans, being DB plans, also have advantages over them too. For example, CB plans generally immunize employees from some investment risks, whereas DC and 401(k) plans don't.
- (5) Cash balance plans eliminate the longevity risk for employees who elect a lifetime pension. DB plans are more likely to provide lifetime pensions than DC plans and 401(k) plans.¹⁰
- (6) Cash balance plans generally provide benefits to almost all employees, whereas many employees don't participate in 401(k) plans, especially low-paid employees¹¹. The

¹⁰ This is also an advantage to the government, because it will be less likely to have to provide public assistance to elderly retirees who have run out of assets.

¹¹ Ibid

employer-provided benefits are generally larger in cash balance plans also.

- (7) Cash balance plans are covered by the PBGC (Pension Benefit Guaranty Corporation) in case the employer falls into financial difficulties and can't make good on the accrued benefits. Thus, employees are guaranteed to get their accrued benefits from the PBGC (in annuity form at retirement - up to certain limits).

Disadvantages to Employees

- (1) Employees may not be happy with low returns on their cash balance notional accounts. As discussed earlier this is often due to informal IRS suggestions in Notice 96-8 discussing IRC §417(e), not the employer. Some employers are providing higher returns in their cash balance plans and court cases have recently ruled in their favor on the §417(e) problem.
- (2) Cash balance plans may not immunize employees from the risk of higher annuity prices when interest rates go down. This also is a function of IRS' current interpretation of 417(e) as applied to cash balance plans (although the law was probably not written with them in mind). This risk can be avoided by keeping the annuity price constant in the plan or by giving some appreciation to the account balances when interest rate go down.
- (3) Many older employees will get lower accruals. In addition, if the employer doesn't provide meaningful transition provisions, there is the pension plateau concern when converting from a traditional DB plan to a cash balance plan, which will be discussed later.

Advantages and Disadvantages to Employers

- (1) Cash balance plans could help manage the employee work force better than traditional DB plans in today's workforce environment - they provide larger benefits to younger employees

which helps hire and retain them, and they don't encourage workers to retire early¹², which is valuable in this period of low unemployment.

- (2) Employers are less likely to have employees who are just hanging around so that they can get their early retirement subsidy.
- (3) Cash balance plans have the funding flexibility of DB plans, so that employers can contribute more in good years, which provides a credit balance so that they can contribute less in difficult years.
- (4) As in any DB plan, employers (and their investment managers) can invest more in stocks to achieve a higher return than if employees did the investing. They can then pass this advantage on to the employees or use it to reduce their costs. Larger pools of investment managed money also creates more efficient markets for a stronger US economy.
- (5) Cash balance plans have more flexibility in determining what benefits get paid to whom¹³. They can be whatever you want them to be (up to the maximum benefit limits as long as there is no unlawful discrimination). For example: (1) early retirement windows are more feasible in DB plans, and (2) employers can easily improve benefits if high inflation hurts the value of the accumulations. Of course, the more bells and whistles, the more complicated they are.
- (6) As discussed above, converting to a cash balance formula avoids many problems. For example, replacing a DB plan with a DC plan or 401(k) plan is considered a plan

¹² However, traditional DB plans may be more appropriate in heavy industries with physically demanding jobs, where early retirement is important.

¹³ For example, an employer could design a DB plan with a formula equal to the greater of two formulas: one, a cash balance type formula, and the other a final pay plan formula, somewhat akin to a floor offset plan all in one.

termination, which entails immediately funding up an underfunded plan and excise taxes on the reversion from an overfunded plan.

- (7) Small employers will also find cash balance plans valuable¹⁴ because (in addition to the above) they are able to provide benefits for missed years before the company was profitable enough to have a plan (i.e., past service benefits), the plan can provide special early retirement window benefits, disability benefits, and survivor benefits (which small companies can find expensive to insure), they can require annuities, they have funding flexibility, maximum benefits are based on ultimate benefits (not each year's contributions) and can increase with inflation, they can get better returns than individuals investing (which reduces employer costs), they are easy-to-understand and participant friendly, employers can provide benefit statements easier, they can have one plan that includes features of a 401(k) plan that everyone wants as a supplement, but there is no fiduciary onus to select funds or provide investment education or fear that participants' account balances will lose principle.
- (8) The rules for cash balance plans are not clear yet, which discourages employers from establishing these plans.

Converting a Traditional DB Plan to a Cash Balance Plan

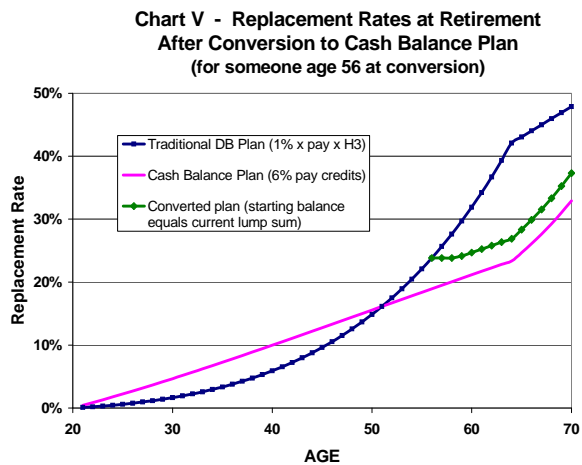
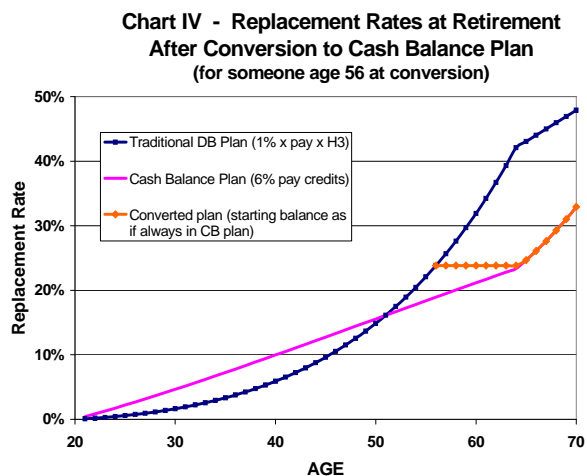
Much of the public criticism of cash balance plans has surfaced not over cash balance plans, but over the conversion from a traditional defined benefit plan to a cash balance plan. In a conversion, the employer has several transition decisions to make (See Chart II). The employer could simply set each employee's starting account balance equal to the value of their accrued benefit under the old

¹⁴ Based on a speech by Carol Sears, President of ASPA, printed in their March 1999 newsletter, where she noted small employers will use cash balance plans more if the rules become clear.

plan. However, this would mean that current participants under age 52 would be worse off. Young employees would have particularly small lump sums for their starting balance. For this reason, many employers provide additional transition benefits (two-thirds of employers in a 1999 Towers Perrin survey of 75 plans). Some of the other employers may provide more stock options or improve their 401(k) match, but note that these changes would probably go to *all* employees, not the ones most hurt by the conversion.

Additional Transition Benefits: One alternative would be to change someone's benefit from the traditional DB benefit (blue line) to the cash balance benefit (red line), as if they had always been in the cash balance plan. Participants in Chart II under age 52 would have a windfall, and it might be difficult for employers to find the old data needed to determine what each employee's account balance would have been. Therefore, some employers phase into an estimate of the cash balance line over 5 or 10 years starting from an initial account balance of zero (and continue the old formula for 5 or 10 years).

On the other hand, older participants would have their future benefits cut, except for the fact that IRC §411(d)(6) prohibits benefit cutbacks to the *accrued* benefit.¹⁵ Chart IV shows the minimum



¹⁵ Note: someone's *projected* benefit *can* be cut. Thus, if the employee works more years, they can get less than what they would have otherwise received. It just can not be less than what they would have received based on the plan and service as of the date of the amendment. In certain state government retirement plans, the state constitution won't allow cuts in *projected* benefits. This is why these states have complex retirement plans with many different tiers of benefits. Once hired, the state can't change your pension plan. If the state ever wants to reduce pensions, then they can only make the change for their new employees. On the other hand, Congress doesn't

benefit that this plan could pay to someone who was, for example, age 56 when the plan converted to a cash balance plan (orange line). Note that the minimum benefit rule causes the pension benefit to plateau for a few years. No pension accruals are earned until the cash balance account catches up with it (which will depend on interest rates in the future). A plateau would also happen if the starting cash balance account was set at the value of the employee's accrued benefit using a higher interest rate than the currently low Treasury rates¹⁶ (or if interest rates were to plummet after the conversion¹⁷). Alternatively, the employer could set the participant's starting account balance equal to the present value of the accrued benefit using current Treasury rates (the blue line). This results in the higher benefits in Chart V (prior page, green line). In fact, if interest rates increase after the conversion, then older participants in this type of conversion could be better off under the cash balance plan, because annuity prices would be cheaper and their account balances would buy a larger pension.

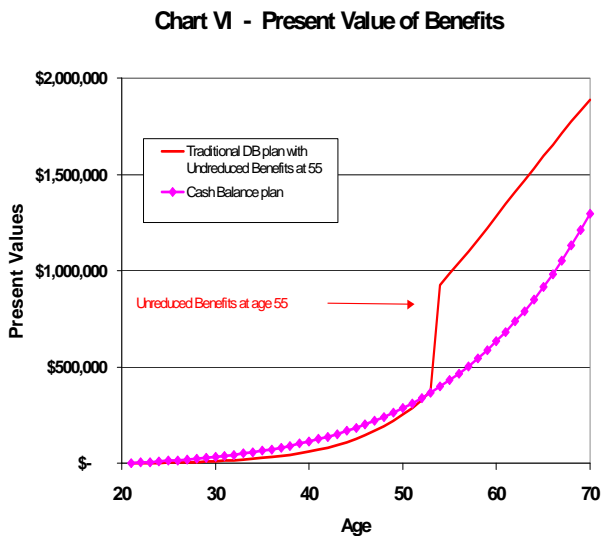
Another transition issue occurs when the traditional plan had a large early retirement subsidy (say at age 55). Employers could put some or all of this subsidy in the starting account balance of anyone

have to follow any rules in this area, and in fact, they cut Social Security benefits in 1977.

¹⁶ Employers might want to do that if they think interest rates will be going back up. On the other hand, they could use a lower discount rate if they think current rates are unusually high.

¹⁷ If interest rates were to plummet, the employer could grant some appreciation to all accounts. However, if interest rates were then to come back up, employers would probably not be able to take it back.

who is already age 55 when they convert the plan to cash balance¹⁸. This creates a large cliff in the starting balance at age 55 as shown on Chart VI.



This leads to the next question. Should someone under age 55 get the prior plan’s early retirement subsidy? They would have received it if they

stayed until age 55 and immediately retired. On the other hand, those who would have left before age 55 (or worked until 65) would not have

received it. Why should the employer put its value in their starting account balance? One remedy that

many employers use is to provide a minimum benefit from the prior plan for 5 or 10 years after the conversion to some or all employees. This gives the early retirement subsidy to anyone who retires within the 5 (or 10) years at a subsidized early retirement age. Those under age 50 (or 45) won’t get the full subsidy. However, they will still get the early retirement subsidy on the accrued benefit as of the conversion date as long as they work to age 55, due to the §411(d)(6) cutback rule.

Other alternatives would be to give current participants the better of the two formulas¹⁹ when they quit or allow employees to elect to stay under the old plan formula (possibly for just 5 or 10 years).

It might make sense even for some younger employees to elect the old plan, if they plan to stay at the company until their unreduced early retirement date. However, these 2 conversion methods

¹⁸ The employer doesn’t have to do this, as long as the participant gets the prior plan’s subsidy on the accrued benefit as of the conversion date per §411(d)(6).

¹⁹ Or just provide the better of the two formulas to certain people for 5 or 10 years.

require the employer to maintain both plan formulas and databases forever and could dramatically increase employer costs beyond those of the traditional plan. That's why employers may limit this to 5 or 10 years. If the employer can't afford higher costs, then some older employees may not do as well, since some younger employees will do better. An October 1998 study by the Society of Actuaries shows that the *number* of people doing better will exceed the number doing worse, because most employees don't stay at their employers until retirement (and they are the ones who will do better).

Disclosure of the conversion: Another major issue that has received attention lately, is how employers disclose information to their employees regarding the conversion. Currently, §204(h) of ERISA only requires employers to inform employees about an amendment that significantly reduces future benefit accruals at normal retirement age. Many employers provide a fair amount of disclosure, but not all do. Thus, some employees won't realize their projected benefits may be much lower because the change can be quite complex. The following remedies have been suggested:

9. *Disclosure would be required whenever a traditional DB plan is converted to a cash balance plan.* Similar pension reductions can also occur when switching to other types of plans (not just cash balance plans) or just by phasing out a DB plan's early retirement subsidies. If disclosure is required only for cash balance conversions, it will bias employers into changing to DC plans, 401(k) arrangements, or other types of hybrid plans. In addition, an employer may start up a plan several months after the termination of the prior plan. Thus, comparisons may need to be required for all reductions, even when the start up of the new pension plan is delayed.
10. *The rule may only apply to companies with over 1000 employees.* This is probably for cost

reasons. Actually a very small company should be able to do individualized statements cheaper than a large company. Thus, an alternative is to apply the rules to all plans. Setting rules just for certain plans creates more problems and techniques for evasion.

11. *Notices could be required for all employees.* Currently under §204(h), notices are only required for employees whose future benefit accruals are reduced. Courts have also delayed the amendment only for employees who didn't get the notice, and of course, this would only affect employees whose benefits were reduced. There doesn't appear to be a reason to *require* notices for everyone, although employers may still send notices to them so they know they are not affected.
12. *Individualized benefit statements would be required:* Some proposals would allow just a range of hypothetical/representative employees because individualized benefit statements could require extensive data gathering, programing, calculations, and decision-making which could take 3 to 6 months and is costly. Some benefit statements would have to be done by hand (e.g., for employees from small acquired or merged companies, employees with breaks-in-service and QDROs, etc.). Individualized benefit statements could mislead employees on what their future pay or benefits might be, or they could mislead the employee into making the wrong decision, or that the new plan will not change in the future (which is very unlikely due to changes in the law, economy, demographics, and employer needs). On the other hand, some employees may not find the alternative acceptable if there are no hypothetical employees similar to them. A remedy might be to allow them to request a hypothetical benefit statement for someone with a similar earnings history and age.
13. *The benefit statement would show the accrued and projected benefits assuming the employee works for 3, 5, or 10 more years or until the normal retirement age.* Too much information

at dates the employee is not interested in or using salary projections that aren't accurate for the particular employee could confuse the reader and it misses a very significant date when many people retire (i.e., the earliest subsidized retirement age). Other alternatives would be to provide:

- a. a computer program that would determine the benefits at dates selected by the employees using his or her pay assumptions, or
- b. just provide at 5 years, the earliest subsidized retirement age, and normal retirement age. Showing the *value* of the early retirement subsidy in the statement for retirement at the normal retirement age (as proposed) doesn't make sense. It would confuse the employee if the value was included at dates before available or after it is no longer available.

14. *The statement must show lump sum values.* If the prior plan didn't pay lump sums, this is forcing a comparison on an item that would never have been paid. In the past, Congress has not wanted to encourage lump sums. In fact, Congress changed the law in 1986 and again 1996 to encourage smaller lump sum cash outs without requiring any timely notification to affected employees. Policymakers should seriously assess this point before requiring lump sum comparisons. All DB plans must offer lifetime pensions, so the comparison can be made on that. Comparisons on lump sums may only make sense if they are payable in both plans.
15. *Some of the assumptions may be specified in law for the projections.* However, they may not be appropriate. For example, one proposal requires that wages and other benefit factors be increased by the median increase in inflation over the past 5 years. In 1983, the CPI was 3% and salaries went up by around 5%. However, the proposed rule would have required 10%.

This would make traditional DB plans look better. On the other hand, suppose the required assumptions produces a low wage increase and a high interest rate. This could unfairly favor the cash balance, DC, and 401(k) plans. An alternative could be to require an Enrolled Actuary to sign off on the assumptions as their best estimate of future experience, just like on government funding schedules for pension plans. Professional standards could be created for this similar to those for life insurance illustrations.

Summary

For many reasons, employers are converting their traditional retirement plans to cash balance plans - a new kind of DB plan which provides many of the advantages of DB and DC plans, and generally increases benefit accruals to younger employees. However, some employees' benefits could be reduced in the transition to cash balance plans (especially older employees with long service). In many companies this may not be a concern because management is looking out for all these employees and will find ways to offset reductions in benefits through options like supplemental 401(k) plans, transition benefits, etc.

Pension changes, though, can be confusing to employees, some of whom may not realize that their future accruals may be decreased. This has led to the introduction of legislation that would require greater employer disclosure to their employees. Before they are enacted it would be beneficial to determine how much compliance would cost and which disclosure method is best at informing participants on what is happening.

The Academy strongly believes that employees should have meaningful information about changes

to their pension plan. We believe that certain basic principles should underlie any disclosure rules:

- Employees should have access to clear and understandable information about their retirement benefits.
- Employees should have timely information about changes to their retirement benefits.
- Participants should be informed as to whether and how a change to their retirement plan will likely affect them.
- Participants should have the opportunity to request relevant information about their specific situations.
- If employees are given a choice of plans, they should be provided the necessary information for comparing the choices and understanding the consequences of their decision.
- The employer-sponsored retirement system is voluntary and already subject to expensive and complex requirements. Thus, any new disclosure requirement should consider its administrative feasibility and costs.

The Academy has developed an approach to disclosure that we believe would satisfy the above principles:

- **Strengthen Section 204(h)** – This section of ERISA could be modified to require plans to clearly describe how the plan is being amended. The new requirement would also call for a written description of which types or groups of employees might be expected to have lower future benefit accruals under the amended plan. The 204(h) notice would be required to inform participants that they can receive more information (beyond that specified later in our

testimony) on their individual situation under the amended plan within six months of the new plan's effective date. Section 204(h) could be expanded to also apply whenever an amendment is expected to significantly reduce early retirement benefits. Current law only requires a notice whenever a plan amendment will result in a significant reduction in the accrual rate for normal retirement benefits. The 204(h) notice would still be required no less than 15 days before the effective date of the plan amendment.

- **Accelerate the Release of SMMs** - In addition to stronger, more meaningful 204(h) disclosure, Congress could accelerate the deadline for distribution of the Summary of Material Modifications. Instead of 210 days after the end of the plan year, as current law requires, employers could be required to furnish their employees with SMMs within 30 days of the effective date of the plan amendment. This would give employees meaningful information about their retirement plan in a timely manner.
- **Require Certain Information on the Amended Plan.** Employers could be required to provide the following information to each participant within a reasonable period of time after the effective date. This would provide employers with adequate time to gather the appropriate information and do the necessary calculations. Taken together, this information should give participants a clear description of their amended plan's initial value and how that compares to the actuarial equivalent value of the accrued benefit under the prior plan as of the effective date of the amendment. Each active participant would receive the following information:

- The estimated accrued benefit payable at normal retirement age under the prior plan as of the effective date of the amendment.
 - The actuarial equivalent lump sum value of the prior plan accrued benefit as of the effective date of the new plan using the assumptions required under Internal Revenue Code section 417(e) (assuming the new plan provides for such distribution if the participant were to cease employment as of the new plan effective date).
 - If benefits under the amended plan are based on a “cash balance,” the participant’s initial account balance (if any) under the amended plan with a description of how it was determined and the assumptions used to develop the initial account balance.
 - An estimate of the annuity that would be provided by the initial account balance payable in the normal form of payment (e.g. life annuity, subsidized joint and survivor annuity or a 10-year certain and life form of payment) under the old plan at the old plan normal retirement age using 417(e) assumptions as of the new plan’s effective date. In order for the participant to make an “apples to apples” comparison between the old plan accrued benefit and the annuity that could be provided by the initial account balance, the forms of payment should be the same.
- **Require Comparisons of Old and New Plans** - Employers could be required to provide a more extensive comparison between the benefits under the old and new benefit formulas for those participants who are given a choice between plans and request such a comparison.