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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

December 12, 2005

Mr. Donald J. Segal
American Academy of Actuaries
Vice President, Pension Practice Council
1100 17th St. NW
Washington D.C. 20005

Dear Mr. Segal:

I am responding to your letter of November 28, 2005, wherein you raised a number of specific concerns about our recent report, *Private Pensions: Information on Cash Balance Pension Plans, GAO-06-42, November 3, 2005*. From an overview perspective and consistent with my prior public comments, cash balance plans represent an innovative and viable vehicle to help enhance the future retirement security of American workers. In my view, assuring their reasonable treatment under the law should be a key element in any comprehensive defined benefit pension reform legislation. In this regard, GAO, like many others, has recommended that the Congress clarify the regulatory treatment of cash balance plans in order to lift any related “cloud of uncertainty.” The balance of this letter seeks to address your concerns and, hopefully, clarify any confusion or misunderstanding you might have about our report.

Your letter largely focuses on our derivation of the “typical” final average pay plan formula that we used in our simulations. You also express some concerns about our general research approach. Finally, you identify some sections of the report where, in your opinion, additional information on certain issues could have improved the report’s comprehensiveness and clarity.

First and foremost, many of your comments relate to the general nature of cash balance plans versus traditional defined benefit plans. Importantly, our report was focused on conversions from traditional defined benefit plans to cash balance plans rather than a general analysis of cash balance plans.

GAO Derivation of the Typical Final Average Pay Plan Formula. An important issue raised in your letter concerns the features of the baseline or “typical” traditional Final Average Pay (FAP) plans that we used in our simulations. Essentially, you expressed concerns that the parameters of the plan were chosen in such a way so that not only is it not representative of typical FAP plans but that it is overly generous, thus generating results are excessively favorable towards the traditional FAP plans. Your concern that our traditional FAP plan is too rich is based the premise that because our traditional FAP plan is also an excess integrated plan, it

should be based on the mean base benefit accrual rate for all excess integrated plans, which BLS data suggest should be 1.07 percent rather than 1.5 percent per year used.

On this engagement, we were tasked to determine how individual participants fared under a hypothetical conversion to a typical cash balance plan compared to a typical FAP plan. (See page 3 of our report.) Therefore, to clarify any confusion on this issue, our baseline or typical FAP plan was **not designed** to be a typical excess integrated plan. We designed our baseline or typical FAP plan to have 1) common private-sector plan characteristics (like excess integration) and 2) a benefit formula that **matches the employer cost** of providing a pension that is **equal to** the average cost of the full variety of FAP plans observed in the BLS Employee Benefit Survey data. (See page 60 of the report text.) Our choice of a 1.5 percent base accrual rate reflects the rate that equilibrates the cost of our plan with the average cost of all final average pay plans, net of the value of their offset provisions.

Importantly, we believe that a 1.5 percent base accrual rate is not atypical when looking at the BLS data on all FAP plans. In fact, as noted in Table 71 of the 2002 National Compensation Survey, a flat accrual rate of 1.5 percent to 1.74 percent is both the mode and median of the flat accrual rates for all final average pay plans and for plans at larger establishments – those with 100 or more employees. We believe that it is methodologically appropriate, given our sample population, a sample of the 1955 birth cohort, to focus on the characteristics of all FAP pay plans.

We put an excess integration feature into our typical FAP plan for two reasons. First, our analysis found that a preponderance of the FAP plans that were converted to cash balance plans had such a feature. In addition, we found that typical cash balance plans had rising pay credits that would provide greater credits to more highly paid and more senior workers. To have used a flat rate would, in our view, have biased our results against our representative or typical cash balance plan. Incorporating an excess integrated feature into our typical FAP plan would make the benefits received by higher income workers between the two plans more comparable.

Nevertheless, given the importance of this issue we have conducted some sensitivity testing of our comparisons, including a scenario where the typical FAP plan is not excess integrated but with all characteristics of the plans otherwise the same. In this instance, removing the excess integration feature from the FAP plan and comparing it to the typical cash balance (CB) plan results in only marginal changes on the number of gainers and losers.¹

Note that a contributing factor to our use of a 1.5 percent rate is that our “typical” plan has only a very small early retirement subsidy. Without such a subsidy, to equalize costs between our typical plan and the average of all plans would require some compensating benefit increase features. The 1.5 percent base rate achieved this equalization.² As your letter suggests, inclusion of a larger early retirement subsidy

¹For example, our sensitivity analysis showed that 86 percent of participants who experience benefit reductions in our initial comparison at age 30 (the third bar on our chart on page 37 of the report) would decline about 0.8 percent. This result would be expected, as only a relatively small number of employees with high average pay are affected by the second accrual rate.

² In converting a traditional FAP plan with an early retirement subsidy to a cash balance plan, a participant is generally still eligible to receive that subsidy to the extent that the participant satisfies the pre-amendment conditions for the subsidy (either before or after the amendment). See 26 CFR 1,411 (d) (3) section 411 (d) (6) protected benefits.

would have reduced the accrual rate of plans and you state that plans that convert are more likely to have larger retirement subsidies. However, based on our plan analysis we were not able to make reasonable estimates regarding the prevalence or level of early retirement subsidies associated with DB plans. In addition, although it may very well be true that FAP plans that have been converted are more likely to have larger early retirement subsidies, we have seen no data representative of the population of converted FAP plans that illustrates this assertion. Furthermore, including an early retirement subsidy would have required additional complexity involving modeling participant behavior responses that would not have assisted us in reaching our research objectives. Although excluding a significant early retirement subsidy could possibly introduce distortions into the analysis, including such a subsidy would likely do so as well. Given our task and for analytical and methodological simplicity, we believe that it made the most sense not to include a significant early retirement subsidy.

I am somewhat puzzled by your comments regarding our efforts to benchmark our plans with other research efforts to simulate the effect on benefits of cash balance plan conversions. As detailed in Appendix IV of our report, we contrasted the cost differences between our typical FAP plan and typical cash balance plan with a widely cited study conducted by Watson Wyatt Worldwide.³ However, you state that the Watson Wyatt Worldwide study is heavily affected by the small number of plans in deciles 5 and 6. We focused on the middle deciles explicitly because we wanted to compare our plan to the middle of the distribution. Further, although data are not available to weight them according to the number of participants, each decile does have the same number of plans.

Concerns About GAO's Research Approach - As you note, we did not base the features of our typical FAP plans solely on those plans that have elected to convert their plans in the past. Further, you suggest that this comparison does not capture the full range of possible outcomes. However, as we stated in our report on page 60:

"While such an alternative could be used to evaluate the effect of past conversions and terminations on affected participants, the results would be limited in predicting the effect of future conversions or terminations on those currently covered by a FAP pension plan."

Given the innovation and variation in plan design within the U.S. private pension system, it is an unrealistic to expect that any single study could possibly capture the full range of real world outcomes. Nevertheless, we believe our study based on a nationally representative sample of cash balance plans and BLS data continues to provide a fuller, more accurate comparison than studies based on a limited number of client case files conducted by private firms.

Finally, we agree with you on the importance of comparing traditional FAP plans and CB plans on a cost-neutral basis, and you refer to a study presented in the October 1998 issue of the Pension Forum. That study analyzed the distributional effect of a final average pay plan versus a cash benefit plan which had benefits of equivalent

³ See Watson Wyatt Worldwide, *The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans* (2000) pp.18-19.

value for workers who terminated employment or retired in a five year window during the early 1990s, before the peak period of conversions.⁴ We conduct such an equal cost comparison in our report (See pages 43 – 49). In our simulations, we compare monthly and lifetime income for workers who are converted at different ages to a cash balance plan over the workers' entire career and not for a truncated period.

Our equal cost simulations also meet two important criteria that we believe should inform any equal cost comparisons. First, we use the same interest rates for all key plan design parameters. Secondly, our simulation of a conversion of a typical FAP plan to a cash balance plan of equal cost delivers economically equivalent benefits over time—the aggregate monetary values of all losses is equal to all gains. In our simulation, aggregate benefits are redistributed as one would expect from a cash balance design and are not reduced.

Other Considerations

Several of your comments regarding our report concern the potential provision of additional information. For example, you note that we did not mention that, in 2001, Congress took a step to modify the disclosure of information to plan participants, and that we did not mention that the wearaway concept has been codified in Treasury regulations. However, while we agree that providing information on either of these developments could be helpful, the focus of our report was not on the issue of disclosure. Although we discuss the concept of wearaway, our simulations explicitly excluded any wearaway effects.

You also commented on our use of the 1955 birth cohort. Regarding this cohort choice as the basis for our simulated population, persons born in 1955 would be in their 40's during the late 1990s, right in the middle of the age-range of workers during a period when cash balance plan conversions were prevalent. The 1955 cohort was also attractive to our simulations because during an earlier engagement, in which we had calibrated the demographic characteristics of this cohort with those obtained by the Social Security Administration's Office of the Chief Actuary.⁵ This calibration increased our confidence in the demographic characteristics' accuracy. Finally, it is true as you state that cash balance conversions could improve benefits over those from an FAP plan for workers above the age of unreduced benefits, which in our model is age 65, and that feature is included in our simulations. However, in general this is a very small group of workers and it does not materially affect our results.

Contrary to scattered press releases that may insinuate otherwise, our report findings do not suggest that there is anything intrinsically wrong with the cash balance plan design. As you know, a cash balance plan of value equal to a traditional FAP simply redistributes benefits away from older to younger workers. (See page 44 of the report.) I have long maintained that cash balance and other hybrid plans may be the best hope for the defined benefit pension system. At the same time, I have noted that, to avoid hurting older participants who have relatively little time to alter their

⁴ See A Benefit Value Comparison of a Cash Balance Plan with a Traditional Final average Pay defined Benefit Plan, by Steve J. Kopp and Lawrence Sher, The Pension Forum, October 1998.

⁵ See Social Security: Program's Role in Helping Ensure Income Adequacy, GAO-02-62, November 30, 2001

retirement saving plans in response, conversions to such plans should be structured carefully. If reasonably designed and carefully crafted, cash balance plans can play a potentially critical role in both stabilizing of the defined benefit system and bolstering the future retirement security of American workers. Indeed, our work suggests that a significant proportion of plan sponsors take positive action to protect these workers in conversions, and that such transition provisions are important and effective measures to take. Specifically, many cash balance conversions (61 to 79 percent) have included some form of transition benefits and, more specifically, 38 to 56 percent of conversions grandfathered older workers under the old plan (See page 35 of our report). Furthermore, as noted in our report, cash balance plans provide better benefits than plan terminations, which is a real alternative to sponsors under our voluntary private pension system. They also offer more certain and secure benefits than traditional defined contribution plans and are insured by the PBGC.

As you note in your letter, the Government Accountability Office has a good working relationship with the AAA, particularly with those who are part of its Pension Practice Council, and we look forward to that continued relationship. As you know, GAO work has a long tradition of professional, fact-based, non-partisan, peer reviewed analysis, which continues under my leadership and can be expected to continue beyond my tenure as Comptroller General. I appreciate your willingness to share your views and concerns, and assure you that I share your strong interest in expanding and strengthening our nation's private pension system.

We are currently considering doing additional work relating to the changing nature of private pensions and savings plans and their role in our overall retirement income security system. We would be pleased to have the Academy of Actuaries involved in this effort to the extent possible and appropriate.

I notice that you have posted your letter to me on your website. Therefore, I ask that you also post this response. Please feel free to contact me, Barbara Bovbjerg, or Joe Applebaum at 202-512-5500, if you have any further comments on this report.

Sincerely yours,

David M. Walker
Comptroller General
of the United States