EAR
ENROLLED ACTUARIES REPORT

The *Enrolled Actuaries Report* is a quarterly publication of the American Academy of Actuaries.
www.actuary.org

VOL. 32 NO. 4 WINTER 2007

TOM TERRY

New Academy VP Stresses Emerging Issues

I'M GRATEFUL TO HAVE THE OPPORTUNITY to serve as the Academy's new vice president for pension issues. As is the custom, I'm going to take this opportunity to share my thoughts about the challenges and opportunities ahead.

As vice president, I chair the Academy's Pension Practice Council, which represents the U.S. actuarial profession in matters relevant to retirement policy. This is no small task considering we are on the cusp of enormous social and financial dislocations as the boomer generation transitions from its productive working years into retirement.

Tom Terry visits Capitol Hill in the snow, February 2005.

Looking ahead, I can assure you we'll continue to address legislative and regulatory matters at hand, such as technical corrections to the Pension Protection Act, promotion of laws and regulations affecting lifetime income arrangements of all sorts (including traditional and non-traditional pension plans), and, of course, the much-anticipated second phase of the Financial Accounting Standards Board's pension accounting project. I know we have to weigh in heavily on these issues.

But we're also going to sharpen our focus on long-

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Inside this issue

BY MIKE PETRAUSKAS

Expensing Stock-Based Compensation

FROM OPTION BACKDATING practices that started being uncovered in 2005, to the Securities and Exchange Commission's (SEC) enhancements to proxy disclosure of executive compensation at the end of 2006, to the innovative plans Google and Zions Bancorp have implemented in the past year, stock-based compensation has been a hot corporate topic. To put these events in perspective, the Enrolled Actuaries Meeting in March 2007 hosted a session on the evolution of accounting for stock-based compensation and the nuances associated with Statement of Financial Accounting Standards No. 123 (FAS 123R).

Controversy

There have been many arguments suggesting that companies should not expense stock-based compensation. For example, some have challenged that the value of these awards cannot be measured accurately, that the award value already is factored into earnings per share dilution, that expensing equity compensation would be unfair to startups

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and technology firms, and that stock-based compensation is a non-cash expense.

Despite these arguments, the awards provide value to employees and are costly to investors. In fact, they provide both an intrinsic value (if they would be worth something if exercised today) as well as a time value that represents potential future increases in award value.

Ideally, equity compensation provides value not only to employees but also to the company offering the awards and to its shareholders.

However, there are costs to each of these groups, and FAS 123R has established a means of recognizing the cost to companies as an expense on their income statements.

Limits of APB 25

From the early 1970s until 1995, Accounting Principles Board Opinion No. 25 (APB 25) provided accounting guidance for equity compensation. Under APB 25, only awards with a positive intrinsic value at grant needed to be expensed. This meant that companies could grant plain-vanilla stock options without having to book an expense. In 1995, FAS 123 was introduced, which allowed companies to elect between expensing their awards based on their grant-date fair value and retaining APB 25. Even though companies that chose to retain APB 25 had to disclose the fair value of their stock-based awards pro forma, most companies chose to retain it. Therefore, not until 2006—when the impact of FAS 123R became widespread—were companies required to attribute expense, based on the grant-fair value of the awards, for all of their stock-based compensation.

Influence of FAS 123R

Under FAS 123R, plain-vanilla stock options no longer receive favorable accounting treatment, so other types of stock-based compensation have become more popular than in the past. The grant-date fair value of stock-based compensation is required to be expensed over the vesting period of the awards. The initial expense should be based on the number of awards that are expected to vest, but this number should be "trued up" once actual experience becomes available. For awards with service-based vesting, companies have the choice of expensing using a straight-line or accelerated methodology. Straight-line expensing attributes the same expense to each vesting tranche, whereas accelerated attribution treats each tranche as a separate award (which inherently causes front-loaded expense attribution).

FAS 123R requires deferred tax accounting treatment of future tax deductions that are expected upon the exercise of non-qualified awards. A portion of the grant-date fair value is set aside as a deferred tax asset. In the future, it is compared to the actual tax benefit realized. Any benefit (windfall) realized above the amount of the deferred tax asset is added to an additional paid-in capital (APIC) pool that can be used to cover future shortfalls. Any shortfalls are offset by windfall that has been accumulated. Any remaining shortfall is a current tax expense.

Ideally, equity compensation provides value not only to employees but also to the company offering the awards and to its shareholders.

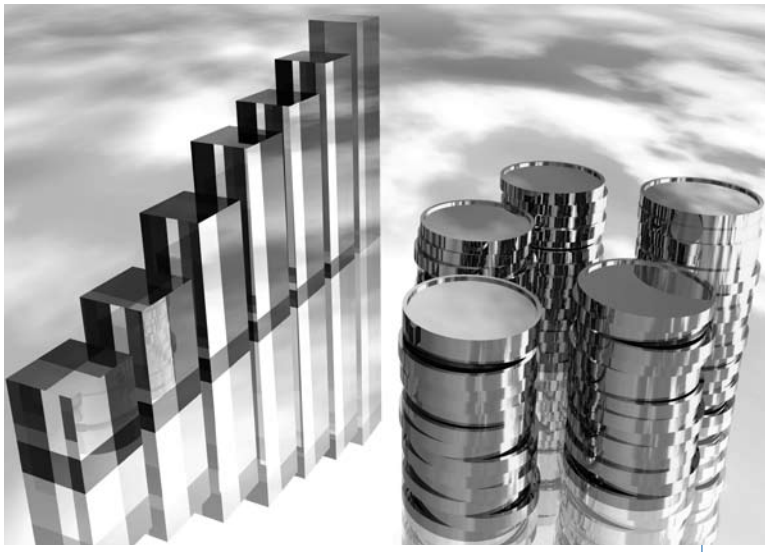
Award modifications have become more popular than ever before, and they require special treatment under FAS 123R. Examples of award modifications include accelerated vesting, exercise period extensions, repricings, award exchanges, and modifications due to equity restructurings. In general, when these scenarios arise, awards should be valued immediately before and immediately after the modification. Any incremental expense created by the modification should be expensed immediately. Essentially, the modification is treated as an exchange of the original award for a new award.

Disclosure requirements for annual re-

ports also have increased. The FAS 123R impact on net income and earnings per share, along with the methodology and assumptions used for the FAS 123R valuation, must be disclosed. In addition, a share roll-forward and disclosure of aggregate intrinsic value are required.

Future of stock-based compensation

Even with FAS 123R, however, stock-based compensation continues to evolve, as highlighted at the end of the EA Meeting session by a synopsis of some events that have grabbed headlines in 2007, like the creative award designs developed by Google and Zions Bancorp. Google is granting its employees transferable stock options—giving them an opportunity to sell, exercise, or hold the awards. This plan went into effect during the second quarter of 2007 and applies to all awards after the initial public offering, including future grants, to non-executives. Meanwhile, Zions is offering employee stock option appreciation rights securities (ESOARS) on the open market that pay out based on the behavior of employees holding employee stock options. Zions has received SEC approval for using the value that the market places on its ESOARS for doing FAS 123R valuations of the stock options that it grants to its employees. This is the first program of its kind that the SEC has approved.



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KAREN GLENN

A Closer Look at Section 411(d)(6)

NEW INTERNAL REVENUE SERVICE SECTION 411(d)(6) regulations, issued in 2005 and 2006, were intended not only to implement changes from the Economic Growth and Tax Relief Reconciliation Act of 2001 but also to clear out the underbrush that had built up in pension plans without eliminating optional forms of value to participants.

The 2005 regulations added two methods to eliminate or reduce Section 411(d)(6)(B) protected benefits:

► **REDUNDANT OPTIONS METHOD** With similar optional forms grouped into families, an optional form may be eliminated if at least one optional form in the same family is retained, and the rights with respect to the retained option are not subject to materially greater restrictions.

► **CORE OPTIONS METHOD** The core options under a plan are a straight life annuity, 75-percent joint and contingent (or both a 50-percent and 100-percent joint and contingent), 10-year certain and life, and whatever is the most valuable option for a participant with a short life expectancy. Under this method, an optional form may be eliminated if, after the option is eliminated, the plan offers a set of core options.

The 2006 regulations added a utilization test that allows for the elimination of certain non-core optional forms that aren't being utilized by participants. An option may be eliminated if it was available to a minimum number of participants within a specified look-back period, and no participant elected the option during that time.

Significant court cases involving Section 411(d)(6) issues include the following:

► ***SHEET METAL WORKERS V. IRS* (2003)**—The plan had a pattern of granting a 13th check to retirees and then stopped granting the check. The IRS disqualified the plan on the basis that a protected benefit had been eliminated. The U.S. Tax Court and 4th U.S. Circuit Court of Appeals disagreed. The 2005 final regulations support the IRS position.

► ***BELLAS V. CBS & WESTINGHOUSE* (2000)**—The plan was

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Updated Social Security and IRS Amounts for 2008

These three tables list updated figures for IRS pension limits, Social Security amounts, and covered compensation for 2008.

Andrew Eisner of Buck Consultants Research Department compiled the tables.

Covered Compensation, 2008

2008 WAGE BASE $102,000

YEAR OF BIRTH	AGE IN 2008	SSRA	SSRA	YEAR OF COVERED COMPENSATION ROUNDED TO			
				$1*	$12	$600**	$3,000
1941	67	66	2007	51,349	51,348	51,600	51,000
1942	66	66	2008	53,954	53,952	54,000	54,000
1943	65	66	2009	56,491	56,484	56,400	57,000
1944	64	66	2010	59,003	58,992	58,800	60,000
1945	63	66	2011	61,480	61,476	61,200	60,000
1946	62	66	2012	63,923	63,912	64,200	63,000
1947	61	66	2013	66,331	66,324	66,600	66,000
1948	60	66	2014	68,591	68,580	68,400	69,000
1949	59	66	2015	70,766	70,764	70,800	72,000
1950	58	66	2016	72,831	72,828	72,600	72,000
1951	57	66	2017	74,820	74,820	75,000	75,000
1952	56	66	2018	76,714	76,704	76,800	78,000
1953	55	66	2019	78,549	78,540	78,600	78,000
1954	54	66	2020	80,331	80,328	80,400	81,000
1955	53	67	2022	83,709	83,700	84,000	84,000
1956	52	67	2023	85,337	85,332	85,200	84,000
1957	51	67	2024	86,880	86,880	87,000	87,000
1958	50	67	2025	88,329	88,320	88,200	87,000
1959	49	67	2026	89,717	89,712	90,000	90,000
1960	48	67	2027	91,046	91,044	91,200	90,000
1961	47	67	2028	92,314	92,304	92,400	93,000
1962	46	67	2029	93,497	93,492	93,600	93,000
1963	45	67	2030	94,663	94,656	94,800	96,000
1964	44	67	2031	95,786	95,784	96,000	96,000
1965	43	67	2032	96,831	96,828	96,600	96,000
1966	42	67	2033	97,791	97,788	97,800	99,000
1967	41	67	2034	98,631	98,628	98,400	99,000
1968	40	67	2035	99,369	99,360	99,600	99,000
1969	39	67	2036	99,986	99,984	100,200	99,000
1970	38	67	2037	100,474	100,464	100,200	99,000
1971	37	67	2038	100,903	100,896	100,800	102,000
1972	36	67	2039	101,306	101,304	101,400	102,000
1973	35	67	2040	101,649	101,640	101,400	102,000
1974	34	67	2041	101,871	101,868	102,000	102,000
1975	33	67	2042	102,000	102,000	102,000	102,000

* Represents exact average of wage bases, as permitted by law and regulations.

** After 1993, IRS does not authorize the use of covered compensation tables rounded to $600 multiples under 401(l). Thus, integrated plans using this table are not safe-harbor plans.

Social Security—2008 Factors

On Oct. 17, the Social Security Administration announced updated factors for 2008.

Wage Base The maximum amount of earnings taxable in 2008 is $102,000 for Social Security purposes.

COLA The cost-of-living increase in benefits is 2.3 percent, first applicable to December 2007 benefits, payable in January 2008.

Wage Index The average annual wage figure of $38,651.41 will be used in computing benefits for workers who become eligible in 2008. This figure is based on data for the last complete year (2006) and was used to determine other wage-indexed numbers given in the table below.

FACTOR	2008	2007
Wage base:		
for Social Security	$ 102,000	$ 97,500
for Medicare	No Limit	No Limit
old-law wage base, for indexing PBGC maximum, etc.	$ 75,900	$ 72,600
Cost-of-living increase (applies to December benefits, payable in January)	2.3%	3.3%
Average annual wage (based on data two years earlier)	$38,651.41	$36,952.94
PIA formula, 1st bend point	$ 711	$ 680
PIA formula, 2nd bend point	$ 4,288	$ 4,100
Maximum family benefit, 1st bend point	$ 909	$ 869
Maximum family benefit, 2nd bend point	$ 1,312	$ 1,255
Maximum family benefit, 3rd bend point	$ 1,711	$ 1,636
Retirement test exempt amount (annual)		
below SSNRA	$ 13,560	$ 12,960
year of SSNRA	$ 36,120	$ 34,440
Wages needed for one quarter of coverage	$ 1,050	$ 1,000
FICA (employee) tax rate:		
Social Security (OASDI)	6.20%	6.20%
Medicare (HI)	1.45%	1.45%
Total	7.65%	7.65%
SECA (self-employed) tax rate, total	15.30%	15.30%

IRS Pension Limits for 2008

Principal Limits

IRC	LIMIT	2008 ROUNDED	2007 ROUNDED	2008 UNROUNDED	NEXT INCREMENT	% INCREASE NEEDED
415(b)(1)	Defined benefit plan limit	$185,000	$180,000	$187,424	$190,000	1.4%
415(c)(1)	Defined contribution plan limit	46,000	45,000	46,856	47,000	0.3%
401(a)(17)	Limit on includible compensation *	230,000	225,000	234,280	235,000	0.3%
402(g)(1)	Limit on 401(k)/403(b) elective deferrals	15,500	15,500	15,866	16,000	0.8%
414(q)	HCE definition	105,000	100,000	105,856	110,000	3.9%
414(v)(2)	401(k)/403(b)/457(b) Catch-up deferral limit	5,000	5,000	5,289	5,500	4.0%

Other Limits

IRC	LIMIT	2008 ROUNDED	2007 ROUNDED	2008 UNROUNDED	NEXT INCREMENT	% INCREASE NEEDED
457(b)	Limit on nonqualified deferrals	$15,500	$15,500	$15,866	$16,000	0.8%
416(i)	Top-heavy key employee definition	150,000	145,000	152,282	155,000	1.8%
409(o)(1)(C)	ESOP payouts, five-year limit	935,000	915,000	937,120	940,000	0.3%
409(o)(1)(C)	ESPO payouts, additional one-year limit	185,000	180,000	187,424	190,000	1.4%
408(k)(2)(C)	SEP pay threshold	500	500	527	550	4.4%

* Governmental plans have special rules for eligible participants as defined in OBRA '93.

Court Rules in Favor of 'Greater-of' Formulas

This article was originally published as an Academy Alert in September. Academy Alerts are published as an information service to subscribers who buy annual paid subscriptions. For more information, contact Justin Edwards, the Academy's legislative assistant (edwards@actuary.org; 202-785-6931).

ON SEPT. 6, the U.S. District Court of Southern Illinois ruled that "greater-of" formulas used to determine pension plans do not violate the Employment Retirement Income Security Act's (ERISA) minimum accrual rules or discriminate against older workers (*Wheeler v. Pension Value Plan for Employees of the Boeing Company* [S.D. Ill., No. 06-cv-500-DRH, Sept. 6, 2007]). In dismissing the lawsuit by Boeing employees, the court found that because a defined benefit pension plan participant's benefits are determined under only the formula producing the greater cash balance benefit, IRS regulations require only that each formula used to determine benefits must separately comply with ERISA minimum accrual rules rather than in the aggregate.

Plaintiffs argued that the Boeing Company's cash balance plan violated the 133-1/3 percent rule because "the accrued benefits of Plan participants must be calculated as the aggregate of their accrued benefits" under the two "competing" formulas. They based their claim on U.S. Treasury Regulation 1.411(b)-1 by stating:

> "[a] defined benefit plan may provide that accrued benefits for participants are determined under more than one formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for participants satisfy [the accrual rules]."

Boeing's cash balance plan allowed for the employee's benefit to be the greater of the benefit determined under a cash balance formula and a minimum benefit determined under a traditional pension formula.

The IRS has been challenging cash balance plans with "greater-of" formulas to demonstrate how combined formulas satisfy the accrual rules on an aggregate basis. The Department of the Treasury is reviewing the IRS position. The Academy's Pension Committee recently sent a letter to Treasury regarding this issue. In the letter, the Pension Committee stated that "there are many other 'greater-of' plan designs not involving a cash balance plan. It is unfair to single out cash balance plans, yet the negative consequences of broadly applying this position would be that much greater."

Execs Discuss Cash Balance Plans at Pension Forum

ACADEMY SENIOR PENSION FELLOW RON GEBHARDTSBAUER moderated a forum on retirement risk-sharing Nov. 15 in Washington that discussed the risks and rewards of "hybrid" pension plans, which have similar characteristics to both traditional defined benefit plans and defined contribution plans. The forum was organized by Divided We Fail, a bipartisan campaign developed by AARP, the Business Roundtable, the Service Employees International Union, and the National Federation of Independent Business devoted to finding solutions to ensure all working Americans have sufficient health care and financial security.

In addition to representatives from The Segal Co. and the Center for American Progress, the forum included executives from Eaton, a global industrial manufacturer, and Honeywell, a global conglomerate consumer products and aerospace systems manufacturer, both of which in the past decade have overhauled their corporate pension plans in favor of hybrid cash balance plans. The September decision by the U.S. District Court of Southern Illinois to rule in favor of Boeing provided cash balance plans further protection from liability. Still, Honeywell Vice President and Deputy General Counsel of Human Resources Kevin Covert expressed frustration with trying to model a corporate pension plan that he believes benefits both employer and employees — yet still facing legal uncertainties due to interpretations of laws and codes by the Internal Revenue Service and the inaction of

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Ron Gebhardtsbauer moderates the pension forum.

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term issues. We are elevating to full committee status our informal Long View Task Force. We're calling it the Committee on Emerging Public Policy Issues. While the demographics of the coming retirement dislocations are inevitable, our society's response is yet to be shaped. I and others on the Pension Practice Council believe that actuaries have the skill set, as well as the responsibility, to shine a bright light on these looming challenges. This new committee will help us identify and frame for policy makers the critical issues well before they turn into legislative proposals.

I also have a couple of additional themes I want to weave into our work on retirement issues: practice advancement and effectiveness.

In a rapidly changing world, our profession can't stand still. We either move forward or we slide back. Practice advancement is absolutely essential for the continued relevance of pension actuaries. So, I'll be working with the Pension Practice Council to identify opportunities to positively influence this area.

With all this work ahead of us, how do we know we're being effective? Are we working on the right issues? Are we ducking the hard issues in order to tackle the easy ones? Are we bowing to the popular view and undermining true practice advancement? Are we communicating clearly? Are we being helpful to legislators, regulators, and the public? Are we crafting understandable messages? Are we having a positive impact? These are tough questions, but they need to be asked and answered.

Incidentally, I think these two themes are related. I think we're bound to be more effective in our work—as individuals and as an Academy—if we're also moving our practice forward.

I'll be giving regular progress reports on all of the above in the *EAR*, so stay tuned.

I have one closing observation. These are very important and exciting times for retirement actuaries. Lots of change, lots of uncertainty and concern—but also lots of need for good, solid actuarial perspective on some very difficult societal issues. With 75 million boomers heading for what will be (for most) a very uncertain retirement, I believe the demands on actuaries to help create and support the financial security systems of the future will be enormous.

So—it's time to get to work!

TOM TERRY, *CEO of JPMorgan Compensation and Benefit Strategies in Chicago, is the new editor of the* EAR *and the Academy's vice president for pension issues. He is the immediate past president of the Conference of Consulting Actuaries.*

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amended to eliminate a special contingent event benefit (unreduced early retirement and a temporary benefit to age 62) payable to permanently separated employees. The 3rd U.S. Circuit Court of Appeals held that the unreduced early retirement benefit could not be eliminated because it is a §411(d)(6) protected retirement-type subsidy. The temporary benefit may be eliminated because it is ancillary. The 2005 final regulations reflect the court's holding.

► ***CALL V. AMERITECH* (2007)**—The lump-sum interest rate and mortality written into the plan gave participants a windfall when electing a lump sum. Although the Retirement Protection Act of 1994 allowed a change to General Agreement on Tariffs and Trade assumptions without violating anti-cutback rules, the plan document included language prohibiting a cutback. The 7th U.S. Circuit Court of Appeals held that the plan must continue using the old interest and mortality as a basis for lump sums.

► ***CENTRAL LABORERS V. HEINZ* (2004)**—The plan provided for a suspension of early retirement benefits while a participant was engaged in "disqualifying employment," i.e., certain jobs with competitors. The plan was amended to expand the list of disqualifying jobs. The U.S. Supreme Court held that Section 411(d)(6) prohibits expanding suspension-of-benefit conditions applicable to early retirement benefits because of past service, even when the expansion is permitted under another code section. The 2006 final regulations reflect the court's ruling. See also: IRS Rev. Proc. 2005-23 and IRS Rev. Proc. 2005-76 for IRS guidance on corrective Heinz amendments.

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Educational Opportunities Abound at 2008 EA Meeting

THE 2008 ENROLLED ACTUARIES MEETING—the first one since the Pension Protection Act's (PPA) new funding rules went into effect—will be held April 6-9 at the Marriott Wardman Park Hotel in Washington. The meeting is co-sponsored by the Conference of Consulting Actuaries and the Academy.

The PPA will play a major role at the meeting. In addition to a series of linked sessions addressing various aspects of the new rules, the meetings will feature independent sessions devoted to other aspects of the act. Attendees can educate themselves on new liability calculations, asset valuation methods, minimums and maximums, funding-based benefit restrictions, and modeling techniques. There will also be explanations on how the new rules affect hybrid plans, age discrimination analyses, participant disclosure, multi-employer plans, and defined contribution plans.

Following up on those topics, attendees can find out how recent sweeping legislation and regulations have dramatically changed the actuary's job with respect to professional discretion to set assumptions, offer strategies to plan sponsors, and comply with stricter future deadlines for actuarial work.

However, PPA will not be the only topic at the meeting. There will be various sessions devoted to small plan practitioners, as well as to a number of professionalism topics, such as the revised qualification and accounting standards. As always, the meeting will feature perennial favorites, including the Gray Book (and Blue Book and Green Book), late-breaking developments, and dialogue with the Treasury Department, Internal Revenue Service, Pension Benefit Guarantee Corp., and the Joint Board.

Those present can also broaden their horizons with sessions on 409A, financial economics, the Governmental Accounting Standards Board (GASB), mortality assumptions in the 21st century, and liability-driven investing. The meeting provides a valuable chance to network with other actuaries and speakers from attending organizations.

For those interested in continuing education opportunities, attendees can earn up to 18 hours of credit by attending seminars before and after the meeting. These include a professional standards seminar, a small firms seminar, a seminar on GASB Part II, and the popular pension symposium featuring discussion of plan freezes and termination issues.

Also, on Monday, April 7, special guest Tucker Carlson, the conservative television personality and host of MSNBC's *Tucker*, will speak to attendees during lunch.

Registration material is available at www.ccactuaries.org. Those who sign up early are eligible for discounts.

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Congress to firmly fix the discrepancy.

"If these plans continue to be under attack … the response is going to be, 'We're out of the defined benefit business,'" Covert said. "'Here's your 401(k). Here's your matching contribution. You're on your own, and don't look at us. Look at the government.'"

Covert said that Honeywell originally employed a defined benefit pension plan that included large incentives for longtime workers to retire early — the "holy grail" of a traditional plan. However, as Americans continue to change jobs more frequently, live longer, and tend to work jobs that aren't as physically strenuous as those of the previous generation, the early retirement bonus is not as appropriate as it once was. When Honeywell realized that only 30 percent of its workers were able to take advantage of those early retirement subsidies, Covert said they decided to restructure their traditional plan into a cash balance plan, which includes elements of a defined contribution plan that enables a mobile workforce to earn valuable pension accruals before changing jobs.

As increasingly many companies offer their employees defined contribution plans such as a 401(k) plan, Gebhardtsbauer noted the variety of risks inherent to a defined contribution pension plan. From an employee perspective, in addition to the risk of market failure, there is also adequacy risk — not knowing if one is putting enough money into the fund — and participation risk — not everyone who is offered participates in a 401(k) fund. Finally, a major risk 401(k) plans generally don't address is longer life spans, adding that about half of all Americans will outlive their life expectancy.

"Everyone doesn't hit life expectancy and fall off a cliff," Gebhardtsbauer said, noting that workers must be financially prepared for longer periods of retirement as a large portion of them will live into their 90s.

However, Gebhardtsbauer also explained how defined contribution plans put risk on the employer by not being able to manage the retention of its employees. When the market is doing well, employees may be leaving because their benefits will be at their highest values. However, that is also the time when the company's production needs will be high to take advantage of the high consumption needs in the market, and the company will need to expand its workforce.

"And when the stock market crashes everybody wants to come back because they need the money," Gebhardtsbauer said, "but that's the time when the company may be needing to lay people off."

Hybrid plans like cash balance plans make sense for both employers and employees, according to Gebhardtsbauer, because they attempt to share the risks between both parties.