



AMERICAN ACADEMY *of* ACTUARIES

Committee on Health, Education, Labor and Pensions
United States Senate

**“Hybrid Pension Plan Coverage:
Retirement Into the 21st Century”**

Testimony Presented By
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Good afternoon Chairman Jeffords and members of the committee and thank you for the opportunity to appear today. My name is Ron Gebhardtshauer and I am the senior pension fellow for the American Academy of Actuaries. The Academy, which is nonpartisan, is the public policy organization for actuaries practicing in all specialties within the United States

Cash balance pension plans have become increasingly popular in recent years. With this increased popularity comes more scrutiny. Congress is now focusing its attention on a few key questions:

- What are cash balance plans?
- Why are employers switching to cash balance plans?
- What is the effect of a conversion on participants?
- What information should participants receive about the conversion to a new plan?

In my remarks today, I will address these questions. I would also like to make the following key points:

- For most people—especially short service workers, lower-paid employees, women and individuals who change jobs several times during their career—cash balance plans can be a good deal. However, some workers, especially middle-aged employees who have many years of service with the same employer and younger employees who spend their entire career with one employer, may have their projected benefits reduced.
- Employees should have meaningful information about changes to their pension plan.
- There are many reasons why employers are converting to cash balance plans. Although costs, at least in the short-term, are sometimes lower after switching to a cash balance

plan, cost savings may not necessarily be a primary motive for the switch. Employers often cite more important reasons for switching. These include adapting to a changing work force, updating their benefits package to be more competitive, making benefits more understandable and predictable to employees and reallocating money to other benefit or compensation programs.

- Many workers near retirement are concerned about reductions in benefits. Current law protects benefits that have already been accrued, but not projected benefits. Proposals to prohibit, or restrict reductions in participants' projected benefits could lead many employers to not provide pension plans.

Background on Pension Plans

Employer-provided pension plans are usually categorized as defined benefit (DB) or defined contribution (DC) plans. Traditional defined benefit plans use a formula to determine benefits. Usually, the formula takes into account such factors as the employee's salary near retirement and length of service. The employer bears the investment risk in a traditional defined benefit plan.

Benefits in a defined contribution plan, such as a 401(k) plan, are based on contributions made to the plan by the employer and the employee and on the investment earnings of the contributions. In most cases, employees make investment decisions and are given a choice of several types of investment funds. Each participant receives an account that clearly indicates how much money the participant would receive if he or she left employment.

Cash Balance Plans

Cash balance plans are treated under law as a defined benefit (DB) plan because their payouts 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 have an individual account feature that makes them 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.

Each year, the plan credits the employee's hypothetical account balance with a percentage of his or her compensation (pay-credit) plus interest (interest-credit). The plan formula specifies the pay-credit and interest-credit rates. For example, the pay-credit rate may be a flat percentage of pay, such as 4% or 6%, for all employees or may vary in some way, such as by age or service.

Similarly, the interest-credit may be based on a fixed rate such as 5%, or vary annually (or more frequently) based on the recent rate of a specified outside investment such as 30-year U.S.

Treasury bonds, the 1-year T-bill rate plus 1%, 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

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.

²The 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 30-year Treasury rate +2%, or the average return on some stock index), then under such proposed guidance, 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 presumably higher interest credit rate). One remedy for this would be for Congress to clarify that if the promise is an account balance with a yield that can be achieved in the markets, then the lump sum could be the

When the participant in a cash balance plan reaches retirement the account is converted to an annuity at the annuity 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). 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, which requires an employee contribution.

Assets and Employer Contributions: Like any DB plan, the employer can invest the combined pension assets 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 contribute more to the plan 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 could be larger than the pay credit rate (e.g., the 6% of pay mentioned above). On the other hand, the pension 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). In addition, the total annual contribution can be lower due to employees that terminate before vesting and can be higher if there are subsidies in the annuity purchase rates.

amount of the account balance. In addition, some employers subsidize (or would like to subsidize) the annuity purchase rate to encourage participants to select annuities. 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.

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 prevalent at one's retirement. However, DB lump sum amounts are not stable. They vary greatly with interest rates. Thus, the employee in a traditional DB plan takes on the interest rate risk if they choose a lump sum. 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 transferred 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 §417(e) whipsaw problem mentioned in a prior footnote. This is a shame, because a consistent purchase rate could encourage more

³ The employer can give the risk and rewards to employees if the plan document sets the interest credit equal to the returns from a market index (or allows employees to elect it).

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 also be noted however, that as people continue to live longer, employers can amend their pension plan (any pension plan, whether cash balance or not) to increase the purchase rates. However, they would have to use the old rate for the prior accruals as a minimum benefit.⁵

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

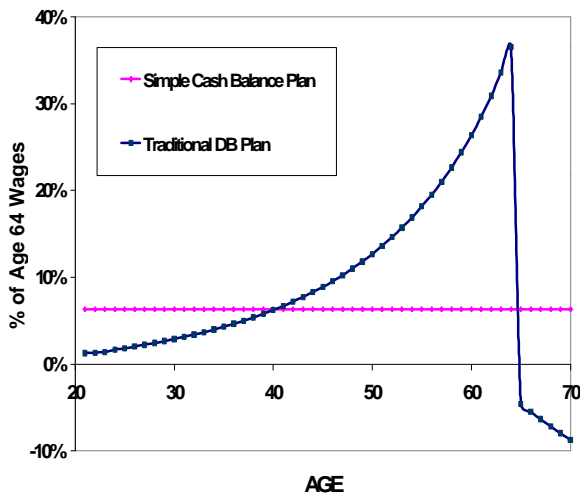
- (1) a *simple* cash balance plan with a flat 6% pay credit and an annual interest credit of 5%, and
- (2) a traditional DB plan with a benefit at age 65 of $1\% \times \text{years worked} \times \text{final pay}$.

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.

You will note that the cash balance plan has fairly level contribution accruals at all ages. They are much larger than the accruals of the traditional DB plan for young employees, but are much

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



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. However, this analysis does not apply to people who change jobs. For

employees who work for two 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 two 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

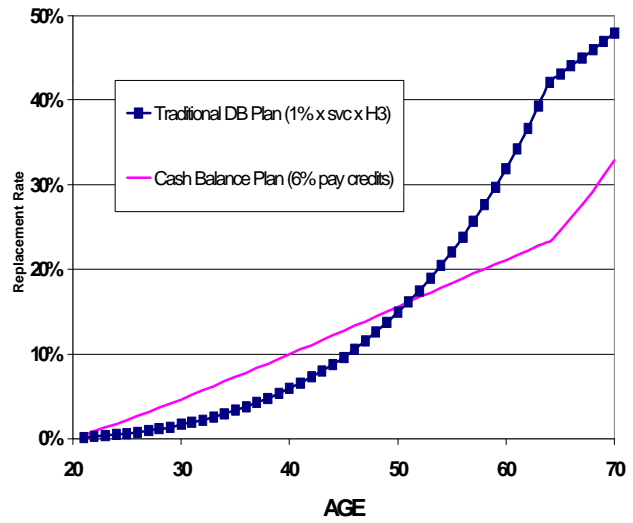
the opposite direction, as there were few cash balance plans when they were young.

Chart III shows the contribution 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). The value of the

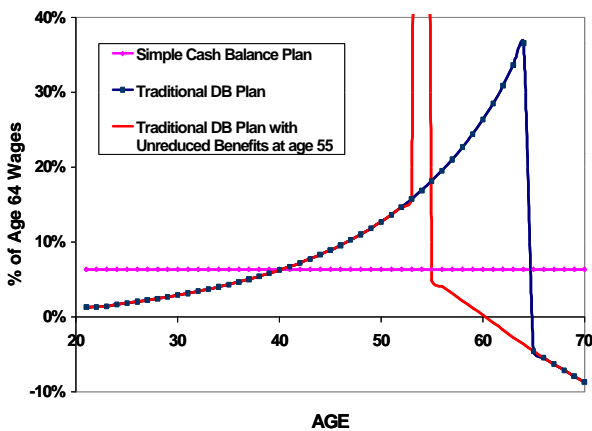
contribution at age 54 could be as much as twice their annual pay. This chart also shows why it would be imprudent to work at the same company much after age 55. If they want to work more,

they might consider retiring from their current company, get the great pension, and find work elsewhere (if possible).

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



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



younger employees.⁶ This is legal as long as the benefits are not impermissibly “back loaded” as

⁶ In fact, a cash balance plan could be made to mimic the steeply back-loaded benefits from a traditional DB plan. This happens in age-weighted profit sharing plans.

defined in Section 411(b) of the IRC. One of these rules requires that benefits purchased at retirement from any one year's accrual cannot 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 plans, which are 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, some cash balance plans integrate their benefits with Social Security. They do so by providing a larger pay credit for income in excess of the taxable wage base 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?

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 their job in the years leading up to the first retirement age, and they don't

push employees out at older ages. In the past, many employers wanted to retain employees to a specified age or service and then encourage them to retire (e.g., due to their 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 encouraging retirement 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.

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 leave the workforce to care for their family.
- (3) Cash balance plans, unlike some traditional defined benefit plans, do not discourage the hiring of older workers.
- (4) Defined contribution plans and 401(k) features have the above advantages also, so why not use them? The response is cash balance (CB) plans, being DB plans, also have advantages over DC and 401(k) plans. For example, CB plans generally immunize

employees from some investment risks, whereas DC and 401(k) plans don't.

- (5) Cash balance plans generally provide benefits to almost all employees, whereas many employees do not participate in their 401(k) plan. The employer-provided benefits are generally larger in cash balance plans also.
- (6) 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 compared to their 401(k) plan returns. As discussed earlier this is often due to IRS guidance in Notice 96-8 discussing IRC §417(e), not due to the employer. Some employers are providing higher returns in their cash balance plans. Court cases have recently ruled for and against employers on this §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 the 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.
- (3) Many long service employees will get lower future 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 accruals to younger employees, which helps hire and retain them, and they don't encourage workers to retire early⁷, 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 to increase benefits or use it to reduce their costs.
- (5) Cash balance plans have more flexibility than a defined contribution plan in determining what benefits get paid to whom⁸. 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

⁷ However, traditional DB plans may be more appropriate in heavy industries with physically demanding jobs, where early retirement is important.

⁸ 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.

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 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 valuable⁹ 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 more easily, 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.

⁹ See 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.

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. The employer could simply set each employee's starting account balance equal to the value of their accrued benefit under the old plan. However, this would mean that participants would get smaller retirement benefits if they stayed until retirement. 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). 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 (had they always been in the cash balance plan). Therefore, some employers phase into an estimate of the cash balance line over 5 or 10 years. On the other hand, under this transition older participants could have their *projected* benefits cut.

However, their *accrued* benefits cannot be cut due to the IRC §411(d)(6) anti-cutback rule.¹⁰

**Chart IV - Replacement Rates at Retirement
After Conversion to Cash Balance Plan
(for someone age 56 at conversion)**

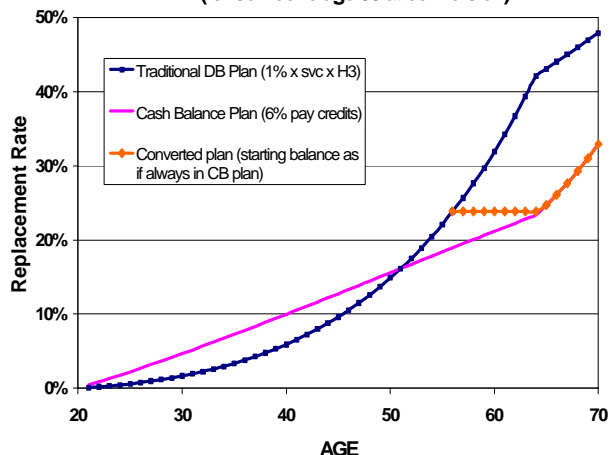


Chart IV shows the minimum benefit that this plan could pay to someone who was, for example, age 56 when the plan converted to a cash balance plan (orange line). Note that the minimum benefit rule causes the pension benefit to plateau for a few years. No pension accruals are earned until the cash balance account catches up with it (which will depend on interest rates in the future). A plateau would also occur 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 rates¹¹.

Alternatively, the employer could set the participant's starting account balance equal to the present value of the accrued benefit using current Treasury rates. This results in the higher benefits in Chart V (green line) and has been suggested as a minimum by Senator Harkin. (One idea would allow the interest rate to be locked in at conversion, so that the account balance

¹⁰ 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 have to follow any rules in this area, and in fact, they cut Social Security benefits in 1977.

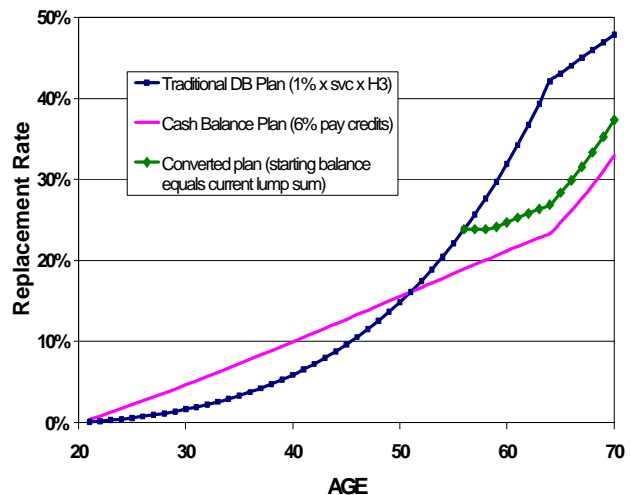
¹¹ Employers might want to use a higher interest rate if they think interest rates will be going back up. On the other hand, they could use a lower discount rate if they think current rates are unusually high.

minimum doesn't fluctuate constantly. 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 who is already age 55 when they convert the plan to cash balance¹². 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 benefits from the prior plan for employees within 5 or 10 years of retirement. 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

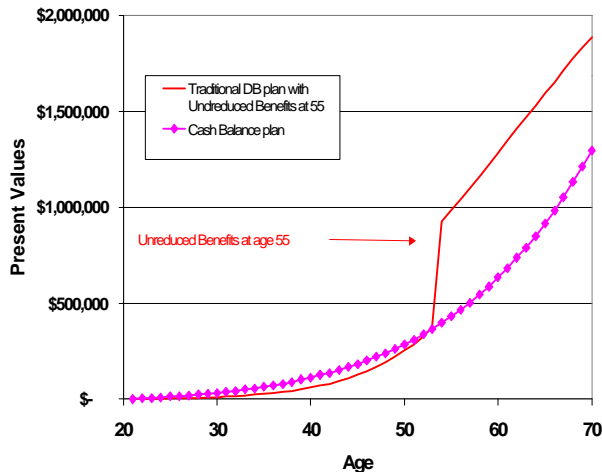
Chart V - Replacement Rates at Retirement After Conversion to Cash Balance Plan (for someone age 56 at conversion)



¹² 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).

conversion date as long as they work to age 55, due to the §411(d)(6) cutback rule.

Chart VI - Present Value of Benefits



Other alternatives would be to give current participants the better of the two formulas¹³ when they quit or allow employees to elect to stay under the old plan formula (possibly for just 5 or 10 years). Some proposals in Congress would require employers to give a permanent choice to all employees¹⁴. If the employee chose the old

plan, they would have to stay in it no matter how long it was until they retired. Thus, their choice could help or hurt them. If they chose the old plan and worked to the subsidized early retirement age (say age 55), then they made the right choice. If they didn't stay until age 55 (or worked beyond age 65), they made the wrong choice. They probably would have received more from the new cash balance plan. Other disadvantages to the one-time choice idea is that it is complicated by corporate transactions that might involve the employees—for example, if a division is sold and the employee no longer has the chance to accrue additional benefits under the plan. Also, if the employer decides it needs to or wants to change the plan (one or both parts) in the future—that would almost certainly require them to give another “one-time” selection. Thus, choice can cause problems, since some employees can choose the wrong plan for their situation (which is not

¹³ Or just provide the better of the two formulas to certain people for 5 or 10 years.

¹⁴ If no choice was provided, the pension plan's surplus would be deemed a reversion and taxed 50% on top of the 35% corporate income tax. Two concerns with that are: (1) it can hurt participants whether it comes out of plan assets or corporate assets and (2) there would be no tax if the plan didn't have a surplus. Some would say this unequal justice is fair, because they would only force a choice if the plan was well funded. However, this provides an incentive against good funding practices.

known at the time of the choice). Choice also requires the employer to maintain both plan formulas and databases for a long time and could dramatically increase employer costs beyond those of the traditional plan. That's why employers may limit this to 5 or 10 years.

One final item to note on these conversions is that costs go up if you improve benefits for younger employees. If the employer can't afford higher costs, then they may reduce the benefits of older employees (and not provide additional transition benefits). An October 1998 study by the Society of Actuaries shows that about 2/3rds of employees will do better under the cash balance plan, because most employees don't stay at their employers until retirement. However, it also showed the average benefit reduction for an older employee (70% to 85% of one-year's wages) was much larger than the benefit increase for a younger employee (10% to 40% of one year's wages). That's because they typically are longer service employees with a larger benefit and the early retirement subsidy is quite large.

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 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 upon request and 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 at age(s) requested by the participant. Employers could satisfy this requirement by providing their employees with

computer programs (accessible on their personal computer, at an employer kiosk, or on the web) into which employees would enter their employment history and assumptions for the future (e.g., pay and future yields) and get comparisons between plans. Since imprudent assumptions about future salaries and investment returns can affect employees' retirement decisions, Congress may want to delegate the setting of assumptions to IRS regulators and the Actuarial Standards Board.

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 middle-aged 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.

However, pension changes 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 and tougher benefit minimums. Before legislation is enacted, it would be beneficial to determine how much compliance would cost, which disclosure method is best at informing participants of what is happening, and the affects on the voluntary pension system.

Thank you again for the opportunity to appear today. The Academy stands ready to assist the committee in any way you feel may be helpful.