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THE CASH BALANCE CONDUNDRUM: HOW TO PROMOTE PENSIONS WITHOUT HARMING PARTICIPANTS

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING UNITED STATES SENATE

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SECOND SESSION

WASHINGTON, DC

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THE CASH BALANCE CONUNDRUM: HOW TO PROMOTE PENSIONS WITHOUT HARMING PARTICIPANTS

MONDAY, JUNE 5, 2000

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 1:05 p.m., in room SD–628, Dirksen Senate Office Building, Hon. Charles E. Grassley (Chairman of the Committee) presiding.

Present: Senators Grassley and Wyden.

OPENING STATEMENT OF SENATOR CHARLES E. GRASSLEY, CHAIRMAN

The CHAIRMAN. Good afternoon, everybody. I will call this hearing of the Committee on Aging to order.

I was waiting for some of our colleagues to come, but early Monday afternoon is not a good time to expect everybody to be here. And if other Members come later on, I will allow them to make opening statements when they arrive.

I thank all of you for joining us today, and as you know from our schedule, we have two panels of witnesses who will help us better understand cash balance plans. They also will suggest solutions for some of the problems of cash balance plans which are a type of defined benefit pension plan.

Currently, there is somewhere between $3 and $4 trillion in defined benefit pension assets. In 1987, there were 111,400 defined benefit pension plans in the entire United States. By 1997—and that is the most recent year that we have figures for—the total number of insured single-employer defined benefit plans had declined from that 111,000 to 44,000, a nearly 61 percent decline.

By contrast, defined contribution plans are growing and growing. In 1996, there were approximately 632,000 defined contribution plans established in the United States. Total assets for both of these types of plans were somewhere between $8 and $9 trillion compared to the $3 to $4 trillion of defined benefit pension plans.

We used to think of retirement plans as being only in one or the other of these two categories. They were either defined benefit pension plans, which guaranteed a certain monthly payment upon retirement, or they were defined contribution plans, which establish contributions for the employer and employee but guaranteed no payment, no specific payment at retirement.

But for the past 15 years, hundreds of employers have converted their traditional defined benefit plan to a cash balance or some other hybrid plans. Hybrid plans offer some advantages over traditional defined benefit plans like simplicity and portability, and then for some additional workers, a better accrual of benefits. Under a traditional defined benefit plan, a final average pay plan, the value of your annuity, spikes upward in the last few years on the job. Under cash balance and similar plans, there is no spike in value at the end of a career. This is because benefits tend to accrue at a more even pace.

This more constant rate of benefit accrual can actually be a disadvantage if you are in the middle or towards the end of your career when the plan is converted. Employees who have worked for years in a backloaded plan only to find that their employer will convert its plan to a more frontloaded one have now spoken out, and very loudly so. And it is many of these workers who are often not in a good position to save more money in order to make up the difference between what they expected to receive from their old retirement plan and what they will get under the cash balance plan.

Unless the plan provides transition benefits, some long-term service employees can be harmed. Because of the controversy over cash balance pension plans, some officials in Government are ambivalent about all defined benefit plans.

I am not ready to write off defined benefit plans. I think they do a decent job in providing a stream of income to people who are no longer in the paid workforce. While I believe that there have clearly been some problems with cash balance plans, I don't think they should be entirely condemned either.

The Employee Retirement Income Security Act, or ERISA, as we call it, was enacted 25 years ago. At that time, retirement plan coverage was hovering around 50 percent. Since ERISA's enactment, there has been no improvement in the formation of defined pension benefit plans. In fact, as we mentioned just a moment ago, the opposite is quite the truth. To me that suggests that the act is flawed.

You can see here from Chart 1 showing the number of single-employer defined benefit plans by State of administration for selected States, and let me say, except in one or two instances, what I did here was take the States which have Senators who serve on this Committee.

This chart shows how defined benefit plans have declined over the last two decades. In 1977, for instance, in my State of Iowa there were 1,082 plans, and by 1987, that number had dropped to 905. But by 1997—no, I am sorry. I said that wrong. In 1987, it had dropped to 905, and by 1997, 508, less than half the number of plans 20 years later.

And you can see for yourself there by looking at the total numbers that Iowa is not unique. Each of the States listed tell very much the same story. Defined benefit plans have become so complicated and so expensive that companies are not keeping them. Those who want to startup a plan will more often startup a defined contribution plan.

Now, we all know that a secure retirement is often likened to a three-legged stool. It should consist of Social Security, private sav-

ings, and a defined benefit pension. But the pensions are disappearing, and Congress should do more, it seems to me, to make them attractive to companies. Defined benefit plans are a waste of time, however, unless participants can have confidence in their retirement program.

So that happens to be one of our tasks as we proceed today. It is to make certain that participants are treated fairly. My concern over the decline in defined benefit plans is one of the reasons why I introduced the Pension Coverage and Portability Act with Senator Bob Graham of Florida. While this is an omnibus reform bill, one set of provisions seeks to expand the formation of defined benefit pension plans. It would strengthen the three-legged stool of retirement security. Our bill does not contain language to regulate cash balance plans, however; so that is what I want to hear from our witnesses this very day.

On our first panel, we will hear from those who oppose cash balance plans, and I would ask the witness to come now. Our first witness is Mr. James Bruggeman, of Tulsa, OK. He is the individual about whom the first cash balance news story was written. He and his company are at the center of this controversy. I welcome you, Mr. Bruggeman.

The AARP and the Pension Rights Center have both agreed to join us. Appearing for AARP is Mr. Joseph S. Perkins, the immediate past President of the organization. And Ms. Karen Ferguson has been the Director of the Pension Rights Center for years. She is here with us today, and welcome to all of you. I hope she is here, anyway.

OK. She would be third, so she will probably be here.

I am going to introduce the second panel when we call them here. So I am going to ask you, Mr. Bruggeman, to start and then Mr. Perkins, and if Karen comes, we will hear from her before we ask questions. So we will start with you, Mr. Bruggeman.

STATEMENT OF JAMES A. BRUGGEMAN, EMPLOYEE OF THE CENTRAL AND SOUTH WEST CORPORATION, TULSA, OK

Mr. BRUGGEMAN. Thank you very much. I appreciate the opportunity to speak today.

My name is James Bruggeman. I am a 28-year employee of Central and South West Corporation, an electric utility headquartered in Dallas, TX. My employer changed from a defined benefit plan to a cash balance plan in 1997. As a result, my benefits were reduced approximately 30 percent. I asked the company for a comparison of my benefits under the old and new plans, but the company refused to provide these comparisons. So I spent several months of my own spare time doing calculations to calculate the difference between my benefits under the old and new plans. Most employees can't do these calculations, and as a matter of fact, probably 95 to 99 percent cannot.

I want to talk about disclosure briefly. I think employers ought to disclose to employees the change in their benefits from a prior plan to a new plan. Further, the IRS should review these disclosures. The disclosure that my employer made leads employees to believe that their benefits change very little, if any, under the new plan. This is not true. Also, in response to questions from the

IBEW, my employer provided information that was misleading, incorrect, and different from the assumptions that the IBEW asked my employer to use in doing those calculations.

Now I would like to turn to a subject called "wearaway," usually referred to as "wearaway," and in order to talk about that, I need to describe what the current law provides.

When an employer changes pension plans, it must provide an employee with what is called a "frozen benefit." The frozen benefit is the benefit under the old plan formula with salary and years of service frozen at the time of the plan change. The form of this benefit is in a monthly annuity, like you described earlier, Senator Grassley.

The cash balance is different. It is like a savings account where you start with a beginning balance and it grows over time, and its form of payment is a lump sum dollar basis.

Of course, the employee has the choice to take the lump sum or the cash balance or the frozen benefit that is guaranteed currently by law. The cash balance is worth far less than the frozen benefit, and the reason for this is twofold:

One, the cash balance plan, the beginning balance of the cash balance plan can be anything the company wants it to be. As a matter of fact, actuaries at their society meetings joke that you could use license plate numbers or shoe sizes or anything for the beginning cash balance. The fact that the beginning cash balance starts off below the frozen benefit means that it is not equivalent to the frozen benefit.

In addition, the cash balance lump sum option does not reflect early retirement subsidies, and these early retirement subsidies are required by law to be included in the frozen benefit. This is another reason that the cash balance benefit is less than the frozen benefit.

I strongly believe that the law should be changed so that the lump sum payment an employee received under a cash balance is at least equivalent to the frozen benefit that is already required by law.

That concludes my remarks.

[The prepared statement of Mr. Bruggeman follows:]

Testimony of
James A. Bruggeman

United States Senate Special Committee on Aging
Hearing on Cash Balance Pension Plans
June 5, 2000

Chairman Grassley, Ranking Member Senator Breaux, and members of the Committee. Thank you for including my written testimony in the hearing record for today's hearing.

My name is James A. Bruggeman. I am a 28-year employee of Central and South West Corporation (CSW) from Tulsa, Oklahoma. In July 1997, my company converted from its traditional defined benefit pension plan to a "cash-balance" pension plan. As a result, I will lose approximately 30% of the value of my pension, which translates into a lump-sum dollar loss well in excess of $400,000.

Disclosure

It took several months of my personal time to gather information and to prepare spreadsheets to make this loss calculation because my employer has refused to provide me with comparisons of my benefits under the old and new plans. My employer has also refused to provide computer software that would allow its employees to make these calculations. Fortunately, I have a background in probabilities and statistics and present value comparisons through my formal education, work experience and hobbies. Without this background, I would have been unable to make the calculations.

For me this is a very serious loss. It may very well change my retirement plans. I would have to work several more years to make up the loss.

My company announced in August 1997 that it saved $20 million in 1997 due to the new plan. And the new pension plan was in effect only six months of 1997. The company also stated that it expected to realize significant ongoing reductions in operating and maintenance expense because of the change. In December 1996, CSW entered into "Change of Control Agreements" with 16 key executives. CSW later reported that these agreements require it to pay the 16 executives $69 million upon closing of a contemplated merger between CSW and American Electric Power Company. In addition, CSW executives have received healthy bonuses in every year since the new pension plan became effective.

Current law allows companies to make these changes to employee pension plans without even disclosing the actual benefit cuts. This is outrageous. My employer's communications to it employees went so far as to lead employees into believing that their benefits were not being reduced. Congress must change the law to require employers to disclose the amount of the benefit reductions. Employees deserve to know how they are being affected.

Not only must Congress change the law to require employers to disclose the amount of the benefit reduction, the law needs to be changed to require the IRS to review these disclosures. As I mentioned above, my employer refused to provide to me benefit comparisons for the new and old pension plans. My employer also refused to provide these comparisons to other employees that requested them.

My employer did respond to the request of the IBEW in 1999 for a comparison of benefits. The IBEW requested a comparison of retirement benefits under the old and new pension plans for employees of various ages and years of service. The IBEW provided the assumptions (such as future pay increases) that it wanted CSW to use in developing the comparisons. However, by duplicating the comparisons that CSW's provided to the IBEW, I discovered that CSW did not use those assumptions and instead used unrealistic assumptions (such as zero pay raises in the future) to drastically skew the comparisons in favor of the new cash-balance pension plan. Moreover, CSW told the IBEW that it had used the assumptions provided by the IBEW. Thus, the need for the IRS to review and approve disclosure information.

Wearaway

One characteristic of cash-balance plans that needs to be eliminated is something called "wearaway". There are two aspects of "wearaway". First, an employer can arbitrarily establish the beginning balance of the cash-balance account. At their society meetings, actuaries have joked that the beginning balance can be anything, including license plate numbers or shoe sizes.

By law, my benefit under the new cash-balance plan cannot be less than the benefit that I had accrued under the prior pension plan. The benefit accrued under the prior plan is often referred to as the "frozen benefit". The "frozen benefit" is the benefit calculated under the prior pension plan formula assuming salary and years of service are frozen at the levels existing on the effective date of the plan change.

The beginning balance of the cash-balance account is often less than the frozen benefit at the time of the plan change. In my case, the beginning cash balance was $296,000 (lump sum) and my frozen benefit (a monthly annuity) at the time of the plan change was equivalent to a lump sum of $352,000. Even though, by law I could effectively receive the $352,000 (in the form of monthly annuities) if I terminated employment at the time of the plan change, it would take two years for the initial cash balance of $296,000 to grow to that amount. That is, it would take two years for the difference between the $352,000 and the $296,000 to wear away to zero. The law should be changed to remove this aspect of "wearaway".

A second aspect of "wearaway" resulted from my employer not reflecting early retirement subsidies in the cash-balance account. By law, the early-retirement subsidies in my employer's prior pension plan must be reflected in the calculation of the above described "frozen benefit". Unfortunately, the law does not require the cash-balance account to include these subsidies. As a result, the balance in my cash-balance account is considerably lower than the lump sum value of the "frozen benefit" and it takes several years for the balance in the cash-balance account to grow to the value of the "frozen benefit". Assuming that I continue to work for my employer, my cash balance does not reach my "frozen benefit" until age 63. I am presently 51 years of age and I was 48 years of age when my employer implemented its case balance plan.

Clever actuaries have intentionally designed the cash-balance account to be worth far less than it should be. The companies adopting these plans know that they will save considerable money if employees take the cash-balance lump sum instead of the "frozen benefit". However, these companies wish this fact to remain a secret. It has been a secret because employers do not have to provide the necessary disclosure information that would reveal a comparison of the two options.

It has also been a secret because the vast majority of employees (perhaps 99% or more) do not have the expertise to make the comparisons by themselves. Appropriate disclosure would unveil this secret, allowing the employee to understand how the cash-balance and frozen benefit options truly compare. Even better, eliminating this aspect of "wearaway" would ensure that these options are comparable.

I respectfully request that you support legislation that will provide the adequate disclosure of the change in benefits that result from a plan change and the elimination of "wearaway".

The CHAIRMAN. Thank you for your suggestion of change in law.

Now, Mr. Perkins. And then I already introduced Karen Ferguson. She, I would like to repeat once again, is the Director of Pension Rights Center for years, and so you go ahead, Mr. Perkins, and then we will go to Ms. Ferguson.

STATEMENT OF JOSEPH PERKINS, OF DANVERS, MA, IMMEDIATE PAST PRESIDENT, AMERICAN ASSOCIATION FOR RETIRED PERSONS

Mr. PERKINS. Thank you, Senator. My name is Joseph Perkins, and I am the immediate past President of AARP, and we appreciate very definitely the opportunity to testify on the age discrimination issues that have been identified under the cash balance pension plan.

Mr. Chairman, under your leadership, Congress passed legislation in 1986 to protect older worker pension rights. As the chief sponsor of the Senate bill, AARP worked closely with you and your staff to ensure that pension plans do not discriminate on the basis of age and also to remove disincentives to older employees to remain in the workforce.

Cash balance plans now challenge the success of that law, we feel. The movement to cash balance plans has been prompted by a desire to reduce pension obligations as the demographic bulge of the baby boomers nears retirement.

For older workers, absent transition relief, this trend is almost always extremely detrimental. The traditional plan provides only a small amount of benefits in the early years, but as the employee ages, the plan becomes more generous. Employers who convert to cash balance plans deprive older workers of the benefit of their increased years of service and their peak earning years, thus breaking the implicit promises made to older workers in the plan.

Employees who may have made career and retirement decisions based upon the plan see their expectations disappear. Instead, their age precludes them from earning comparable benefits under the new plan. In addition, many older workers may suffer a wearaway period. You mentioned it, Mr. Bruggeman mentioned it: a period of time when no benefits are accrued under the new plan. Effectively, the employee's benefit is frozen, and age is a critical element.

If the plan has two employees with the same years of service and same salary, with the only difference being age, the older employee will experience the larger wearaway. Since the wearaway is based directly on age, it violates, we believe, current law.

As a result, older workers often experience a double whammy: loss of a more beneficial defined benefit formula as well as the potential for no new benefits at all. This often means dramatic reductions in expected benefits.

Why does this occur? Cash balance plans are defined benefit plans that have been repackaged to look like defined contribution plans. Instead of defining the benefit in terms of an annuity at retirement, as the law requires, cash balance plans attempt to portray a participant's benefit as a lump sum amount which increases with time. However, cash balance plans are not defined contribution plans. Benefits in a cash balance plan are not based upon ac-

count balances and investment performance, but are determined by a benefit formula that is defined in the plan.

Congress recognized the difference, and the law prohibits the reduction of accruals in defined benefit pension plans based on normal retirement age, not the account balance. This is the fundamental flaw in the cash balance design. There is no question about how the math works. If two employees have the same compensation and the same years of service, the amount of the younger employee's annual accrual will always be greater than that of the older employee. This violates current law which prohibits reductions based upon age.

Inadequate disclosure is also a problem. Under current law, an employer need not describe how a cash balance conversion impacts the individual's benefits. AARP believes that it is essential that each affected employee be provided with a personalized statement that provides a comparison of the benefits under the old and new plan design.

Many companies, recognizing the harm to older workers, have provided various remedies to their workforce, such as permitting older workers to stay under the old plan formula. However, proponents do not believe the inequities should be addressed as a matter of public policy. But the age discrimination laws were intended to prevent some of the very practices inherent in cash balance plans. Therefore, we must better protect older workers.

Cash balance plans can and should be brought into compliance with the age discrimination laws. As one option, their benefit accrual formulas can be redesigned to increase the accruals provided to older employees.

Another option is to grandfather workers under the traditional defined benefit formula or to give employees the choice of remaining under the old plan.

While these options do not address the legal issues, they do address the adverse impact on older workers that occurs in a conversion and, thus, should also be pursued.

We appreciate the fact that this committee has begun the review of issues raised by cash balance plans. We look forward to assisting this committee and others to ensure that these plans fully comply with the requirements of current law and, in particular, the prohibitions against benefit reductions based on age.

Thank you.

[The prepared statement of Mr. Perkins follows:]

TESTIMONY

BEFORE THE

SENATE SPECIAL COMMITTEE ON AGING

ON

CASH BALANCE PENSION PLANS

JUNE 05, 2000

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SUMMARY

The ADEA, and companion provisions in the Code and ERISA, prohibit the ***reduction*** in (or cessation of) benefit accruals based on age. The overall objectives of these provisions are two-fold: to assure that pension plans do not discriminate on the basis of age and to remove disincentives to older employees to remain in the workforce. In general, cash balance plans violate both the letter and spirit of these provisions. As a result, both the cash balance formula itself, as well as a conversion of a traditional plan to a cash balance plan, violate current law.

There is no dispute that cash balance plans are, by definition, defined benefit plans. Cash balance plans must therefore operate according to the laws and rules governing defined benefit plans. From that fundamental proposition every other requirement follows: cash balance plans must define their benefit in terms of an annuity commencing at normal retirement age; cash balance plans may not provide a single sum benefit that is less than the present value of the normal retirement annuity; the present value must be calculated using stated actuarial assumptions that are consistent with the statutory limits; benefits must accrue at a rate that satisfies the anti-backloading requirements; and, benefits must not accrue at a rate that reduces benefit accruals based on age.

It is a mathematical fact that, absent other offsetting factors, a cash balance plan with a uniform hypothetical allocation and interest credit rate will provide lower benefit accruals to employees solely because of their age.

In addition, in a conversion, employees (particularly older longer service employees) may experience a period of time when *no* new benefits are accrued (the "wearaway"). While salary and service may be components in determining a wearaway, all else being equal, age is the determining factor of the amount of wearaway. Because the calculation of the wearaway is based directly on age, it also violates the pension accrual laws.

For older workers, absent transition relief (e.g., "grandfathering" employees in the old plan), the conversion to a cash balance plan is extremely detrimental. By depriving older workers – especially those with long service – of the benefit of their increased years of service and their peak earning years (including any early retirement subsidies), employers who convert break the implicit promises made to older workers in the traditional defined benefit pension plan. These employees may have made career and retirement decisions based upon the expectation of certain benefits, only to see that expectation disappear -- replaced by the new cash balance plan formula that reduces – or eliminates -- benefits based on age.

Some promote the design of cash balance plans as a beneficial hybrid of the common features of a traditional defined benefit and a defined contribution plan. But the problems for older workers caught in a conversion of a current defined benefit plan outweigh any potential benefit of the cash balance design. As we address the legal and policy issues raised by cash balance plans, we must protect older workers.

AARP is pleased with the opportunity to present its views on the important issues raised by the recent trend towards converting a traditional defined benefit pension plan to a "cash balance" pension plan. AARP has become increasingly concerned about the significant age discrimination issues that arise both within the cash balance formula itself and when employers convert defined benefit pension plans from a traditional formula to a cash balance formula. Cash balance plans _per se_ reduce benefit accruals for older workers. Furthermore, depending upon the design of the plan conversion, the change to a cash balance formula results in a legally impermissible reduction in the rate of benefit accrual, often including a period of many years when older workers accrue _no_ additional retirement benefits whatsoever. In general, older workers are most harmed by a conversion, and have less time to recover from a conversion and concomitant loss of retirement benefits, because they are closer to retirement and cannot save enough to make up this loss.

AARP believes that a careful review of the legal distinctions between defined benefit and defined contribution plans makes clear that the most common designs for cash balance plans violate the benefit accrual provisions of the Internal Revenue Code (Code), the Age Discrimination in Employment Act (ADEA), and Employee Retirement Income Security Act (ERISA).

I. THE ADEA PROHIBITS AGE DISCRIMINATION IN PENSION PLANS

Section 4(i) of the ADEA prohibits the ***reduction*** in (or cessation of) benefit accruals based on age.[1] ADEA § 4(i) and its companion sections in the Code and ERISA, enacted in 1986, highlight Congressional concern about fairness to older workers in the operations of pension plans. The overall objectives of the amendment were two-fold: to assure that employee pension benefit plans do not discriminate on the basis of age and to remove disincentives to older employees to remain in the workforce, *see* 29 USC § 623(i). Prior to OBRA,[2] many plans made older workers face a cruel choice – retire, or watch the value of their retirement benefits erode substantially.

The legislative history of OBRA demonstrates Congress' concern about the diminished value of pension benefits for older workers whose accruals may be reduced or ceased based upon

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[1]ADEA § 4(i)(A), 29 USC § 623(i)(A), makes it unlawful for an employer to establish or maintain an employee pension benefit plan which requires or permits (A) in the case of defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age.....

[2]AARP believed that the ADEA required continued contributions, allocations, and accruals under employee pension benefit plans _before_ its amendment by OBRA of 1986. This position was supported by federal courts; *American Association of Retired Persons v. Farmers Group, Inc.*, 943F.2d.996 (9th Cir. 1991 cert. denied), and the EEOC, which voted twice (June 1984 and March 1985) to amend its regulations to require pension plans to continue such accruals.

their age. Indeed, Congress engaged in a sophisticated balancing of the significant and substantial benefits of continued benefit accruals to older workers (as well as the potential savings to the federal Treasury due to continued employment of those workers), against any costs to employers for providing such accruals. Senator Charles Grassley (R-IA), the primary sponsor of the OBRA amendment requiring continued accruals, engaged in precisely this type of analysis. More importantly, the initial Senate amendment's language limited to post-age 65 accruals eventually gave way to the broader prohibitions against discrimination based on age that was enacted as part of OBRA.

In enacting OBRA, Congress clearly recognized that defined benefit and defined contribution plans, and their accrual methods, are fundamentally different. Accordingly, OBRA contains two differently-worded sections: one prohibiting the cessation or reduction of *accruals* in defined benefit pension plans (*see* fn. 1, *supra*), and one prohibiting the cessation or reduction of *allocations* in defined contribution plans.[3]

II. CASH BALANCE PLANS ARE DEFINED BENEFIT PLANS AND MUST DEFINE THE BENEFIT IN TERMS OF AN ANNUITY PAYABLE AT RETIREMENT

Cash balance plans are defined benefit plans that have been repackaged to look like defined contribution plans. "Even though the cash balance plan resembles a defined contribution plan, it is as a matter of law a defined benefit plan."[4] However, instead of defining the benefit in terms of an annuity payable at retirement, as traditional defined benefit plans must do, cash balance plans attempt to portray a participant's benefit as a lump sum amount which increases over time. Because of this repackaging, a number of features that usually distinguish defined contribution and defined benefit plans have been blurred, further concealing numerous legal, technical, and policy issues. The conversion of a traditional defined benefit plan to a cash balance plan formula raises additional legal and policy issues, and results in a range of winners and losers.

Since cash balance plans are defined benefit plans,[5] the accrued benefit must be "expressed in the form of an annual benefit commencing at normal retirement age....," 29 USC § 1002(23)(A), or its actuarial equivalent. *See* 29 USC § 1054(c)(3); 411(a)(7)(A)(i); Treas. Reg. 1.411(a) -7(a)(1). The benefits are determined by the formula set out in the plan, <u>not</u> by

[3]ADEA § 4(i)(1)(B), 29 USC §623(i)(1)(B) prohibits; "...in the case of a defined contribution plan, the cessation of allocations to an employee's account, or the reduction of the rate at which amounts are allocated to an employee's account, because of age." *See also*, 29 USC § 1054(b)(2)(A), *Code*, 26 USC §411(b)(2)(A).

[4]Testimony of Stuart L. Brown, Chief Counsel for the Internal Revenue Service, before the Senate Committee on Health, Education, Labor and Pensions, September 21, 1999, at 3.

[5]ERISA defines a defined benefit plan by exclusion, that is, as any pension plan that is not an individual account plan. *See* ERISA § 3(35), 29 USC § 1002(35). For a comparison of the purposes and structural differences between defined benefit plans and defined contribution plans, see *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 119 S.Ct. 755, 761-62 (1999).

the assets that may accumulate in one's "hypothetical account." As with all other defined benefit plans, the Code imposes upon cash balance plans rules governing the timing of benefit accruals, valuation of benefits, the certainty of benefit determinations, and rules governing the expression of accrued benefits, among other requirements. *See* Code §§ 411(b)(1), 417(e), 401(a)(25) and 411(a)(7)(i). These requirements are all designed to ensure that the promise made to employees of a stream of payments to replace the wages lost at retirement is not rendered illusory by deceptive or ill-advised plan designs.

In most cash balance plans, the benefit is defined by reference to a "hypothetical account." The hypothetical account is attributed with an annual pay credit (usually a percentage of pay, such as 5 percent of pay each year), plus a hypothetical rate of return (usually tied to an index, such as the 30-year Treasury bond rate) on the assets. As in all defined benefit plans – and to highlight the hypothetical nature of these "individual accounts" – the employer is permitted flexible funding, meaning at any given time there may be more benefits promised in the hypothetical accounts than there are assets in the plan.

Generally, when an individual retires, the benefit must be converted to an annuity at the price specified in the plan. In addition, upon termination of employment, cash balance plans generally permit employees to take a lump sum. However, since the amount of the lump sum is determined by the plan formula and certain requirements in the law, the actual lump sum payment may be different than the amount in the hypothetical account.[6]

Similar to other defined benefit plans, the employer contributes assets to the cash balance plan and manages the plan. The employer contribution obligation depends upon its estimate of the present value of total future benefit obligations, not on fixed or promised annual contributions to individual accounts. Depending upon the accuracy of its estimates on cost and the plan's investment returns, the employer's contribution obligation (if any) changes every year. *Nachman Corp. v. Pension Benefit Guaranty Corp.*, 446 U.S. 359, 363 n. 5 (1980). Employers generally assume the investment risk, but if plan returns are better than needed to fund benefits, employers also receive the rewards. Since defined benefit plan rules allow for flexible funding, any investment difference can be made up over several years.

III. THE REASONS EMPLOYERS CONVERT TO A CASH BALANCE PLAN

The explosion of cash balance plans has been almost entirely the result of conversions from existing traditional defined benefit plans. An estimated twenty percent (20%) of the Fortune 100 companies have converted their plans, covering close to 10 million workers. In a survey published last year, the magazine PENSIONS & INVESTMENTS stated that at least 325 companies had converted to cash balance plans with holdings of a minimum of $334 billion in assets.

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[6] The actuarial assumptions used to convert benefits from a monthly annuity at age 65 to different forms including a lump sum distribution must be stated in the plan document. See IRC § 401(a)(25); Rev. Ruls. 79-90, 1979-1. C.B. 155, 81-12, 1981-1.C.B. 228.

There is no question that the movement to cash balance plans has been prompted by a desire to reduce pension obligations as the demographic bulge of "baby boomers" nears retirement – and hence moves through the years of greatest pension cost to employers (and greatest pension value to the employees).

Among reasons employers convert to cash balance plans:

- To save money, reduce overall plan costs, and limit their future benefit obligations to aging workers;
- To redistribute the benefits under the plan from older longer service workers to younger and newer workers;
- To eliminate early retirement subsidies from the plan;
- To avoid income and excise taxes if a defined benefit plan is terminated;
- To take advantage of the "spread" between what employers promise in interest credits and what the plan actually earns (the interest arbitrage); and
- To increase employee appreciation, since many employers believe that the traditional defined benefit plan is not well-understood.

IV. THE ADVERSE IMPACT OF CONVERSIONS ON OLDER WORKERS: BREAKING THE PENSION PROMISE

For employees, the change in plan design to a cash balance plan can have significant impact. For older workers, absent transition relief, it is almost always extremely detrimental. By depriving older workers – especially long service older workers – of the benefit of their increased years of service and their peak earning years (including any early retirement subsidies), employers who make this dramatic plan change break the implicit promises made to older workers in the traditional defined benefit pension plan. These employees may have made career and retirement decisions based upon the expectation of a certain pension benefit, only to see that expectation disappear – replaced by the new cash balance plan formula under which their age precludes them from earning comparable benefits. In addition, some older workers may suffer a wearaway period – a period of time when no new benefits are accrued under the new plan. Older workers thus experience a double whammy – loss of the more beneficial defined benefit formula, as well as the lack of time to benefit from the new plan formula (with the potential for no new benefits at all).

The conversion to a cash balance plan thus adversely affects older, longer service workers in several ways:

- It deprives them of the benefits derived from long service and a higher salary they would have received in the traditional defined benefit plan. A traditional defined benefit plan generally has a benefit formula that is based on number of years worked and final average salary. In addition, the annuity value is determined by number of years from retirement

age *with greater value for those closest to normal retirement age.* This design provides smaller value in the early years of employment, with the greatest value coming in the last years of employment. Older workers are rewarded under this type of formula, especially if they are long-service workers. Younger, more mobile workers receive less value from this plan design. A younger worker covered by a traditional formula, in addition to being many years from retirement age, generally has a lower salary and a smaller number of years of service. The result is a small benefit after only a few years of work. As one begins to approach retirement age, and as one's salary and number of years in the plan increase, benefits begin to grow more dramatically. The bulk of benefits can be expected in the years just prior to retirement.

- It deprives them of early retirement subsidies often provided in traditional plans. The effect of increasing age and higher salary can be magnified by eligibility for an early retirement subsidy. Many traditional defined benefit plans include such a subsidy, generally based on number of years of service and/or age. Older employees who become eligible for these subsidies can see an additional spike in the value of their pensions. Many conversions include the elimination of these subsidies. In addition, when employers convert to a cash balance formula and choose an opening account balance for the new plan, the employer often ignores the value of the early retirement subsidy in computing the actuarial equivalent of the old plan benefit.

- Depending upon the conversion formula, older workers may be subject to a significant "wearaway," causing them to work for many years before earning any additional retirement benefits. Compounding the adverse impact of the change in benefit formula, the benefits under the new plan, in essence, may take many years to catch up to the benefits already earned under the old plan formula. During this catch-up period, the employee would accrue no new benefits. This stands in sharp contrast to the expectation that their final years of service would result in the greatest increase in their retirement benefits.

- Older workers are disadvantaged because they have fewer years in which to accumulate significant pension amounts under the cash balance formula. A typical cash balance formula provides for a much larger accrual of benefits at an earlier age than a traditional defined benefit plan. Since a younger employee has a longer period of time before normal retirement age, the amount in the plan's hypothetical account will continue to earn interest credits for a much longer period of time, leading to greater benefits. Fewer years until normal retirement age means older workers have less compounding and thus smaller benefits.

As a result, the conversion to a cash balance formula has the practical and substantive effect of often dramatically reducing or ceasing accruals to the pensions of older and/or long service workers. Older employees have reported reductions in their expected benefits in the tens and

even hundreds of thousands of dollars. In contrast, younger workers who had accumulated little under the prior plan design, may see a significantly higher accrual rate.

An employee accepts small benefits in the early years of the traditional plan in return for the promise of greater benefits as one continues to work. The change in plan design to a cash balance plan undermines completely that benefit trade-off. Older workers find that having completed those years in the traditional plan when benefits were small – and having now reached the stage when benefits will begin to grow considerably – the conversion to the cash balance plan no longer provides those expected higher benefits. Despite having worked for years under a plan design that gave small benefits at the beginning but promised higher benefits at the end of one's career, these same employees are suddenly switched to a pension package that provides the very opposite.

Many employers, having recognized the adverse impact on older workers in a plan conversion, have employed a variety of mechanisms in an effort to minimize the harm. For example, some employers have given current workers the option of remaining under the old plan formula. This generally ensures that an older, longer service worker is not hurt in a transition from one plan design to another. However, there is no requirement to offer such a choice. While extending such a choice is one option to protect older workers, too few companies have provided for plan choice, and fewer still extend that choice to all workers. Most often, that choice is for a limited period of time, and only to those older workers closest to retirement age.

Other companies have recognized that, since older workers have fewer years prior to retirement age to accumulate benefits under the new plan design, the formula should be adjusted to give a higher pay credit to older workers. While such provisions at least recognize that older workers have been adversely impacted by the conversion, enhanced credits generally do not make the older worker "whole" by providing benefits equal to that which would have been provided under the old plan.

V. RATES OF ACCRUAL IN A CASH BALANCE PLAN ARE REDUCED AS A PARTICIPANT AGES

A. Accrual Rates in Traditional Defined Benefit Plans

In virtually all traditional defined benefit plans, the *rate of benefit accrual* either (a) remains the same for all employees regardless of age, or (b) increases based on age (limited by the statutory rules on backloading). In addition, in a traditional defined benefit plan, the actuarial present value (also referred to as the "lump sum" value) of each year's accrual *increases* as the employee approaches normal retirement age. These increases in value are caused, in part, by increases in salary for older workers which are "typically earned in the worker's final years of employment."[7] The increase in value of later accruals is further escalated in plans that provide a subsidized early retirement benefit.

[7] *See* Testimony of Treasury Benefits Tax Counsel J. Mark Iwry before the Senate Committee on Health,

B. The Reduction of Benefit Accrual in Cash Balance Plans

On the surface, cash balance plans seek to mimic the operations of a defined contribution plan by establishing hypothetical "individual accounts" representing an individual employee's accrued pension benefit. Typically, a participant in a cash balance plan receives annual interest and compensation credit. Each participant has a hypothetical account balance which increases annually as hypothetical allocations of interest and compensation occur. The plans typically define the benefit as the single sum amount of each employee's hypothetical account balance. When a participant in a cash balance plan reaches retirement, the account is converted to an annuity at the annuity price specified in the plan.

But, cash balance plans are not defined contribution plans. Because the benefit is not expressed in the form of an annual benefit commencing at normal retirement age (as is required for a defined benefit plan), the Service stated in IRS Notice 96-8 that cash balance plans would have to provide the actuarial equivalent of a benefit expressed in such a form and described how that is to be accomplished: a cash balance plan must determine the benefits payable at normal retirement age by reference to the hypothetical account balance as of normal retirement age, "*including benefits attributable to interest credits to that age.*" *See* IRS Notice 96-8, 1996-6 IRB 23 at 24 (emphasis added).

Despite some protests to the contrary, Notice 96-8 is correct: the interest credits are the essential component of the accruals in a cash balance plan. Defined benefit plans require a present determination of what the benefit will be worth to the employee at age 65. The only way for a cash balance plan to be consistent with the required operations of a defined benefit plan is to utilize future interest credits in the calculation of accrued benefits.

If future interest credits were not included in the current calculation of the accrued benefits, but were accrued only in future years, the compounding over time would dramatically increase the amount of accruals in future years. As a result of this compounding, cash balance plans would inevitably run afoul of the "backloading" limitations set forth in the Code.[8]

The following table shows the benefit accrual pattern (as a percentage of salary), by age, under a cash balance plan providing for a pay credit of 5% per year and an interest credit equal to 6% to normal retirement age.

Education, Labor and Pensions (September 21, 1999), at 3.

[8] IRC § 411(b)(1)(A) - (C).

Rate of Benefit Accrual Declines with Age*

Age	Pay Credit During Year	Projected Value at Normal Retirement Age	Benefit Accrual At Normal Retirement Age	Rate of Benefit Accrual
30	$2,000	$15,372	$1,444	3.6%
40	$2,000	8,584	716	1.8%
50	$2,000	4,793	450	1.1%
60	$2,000	2,676	251	0.6%

Source: *Poulin Associates, Inc.*
* Assumes annual earnings of $40,000; Normal Retirement Age of 65; Pay Credit of 5%; Interest Credit of 6%; Discount Rate of 6%; Mortality According to GATT

As evident from this table, the accruals vary directly with the age of the participating employees notwithstanding comparable salaries. In contrast to traditional defined benefit pension plans, where the accrual rates are either constant or increase based on age, the accrual rates in cash balance plans decline dramatically based on age when all other factors are constant.

The reduction in the accrual rate is an inevitable result of the method by which future interest is allocable to the hypothetical compensation credits in the year in which the contribution occurs. While similar contributions and interest allocations would be permissible in a defined contribution plan, defined contribution plans are plans based solely on the amount contributed to the participant's individual account, and any gains or losses allocated to such account. *See* IRC § 414(i). There is no corresponding requirement in defined contribution plans to calculate the present value of future obligations because there are none.

As noted repeatedly, however, cash balance plans are not defined contribution plans. Benefits in a cash balance plan are not based upon actual account balances, but are determined by use of the benefit formula in the plan. Benefits in the hypothetical account are not related to the investment yield of the plan's assets. The hypothetical account is not credited with gains or losses, and the amount of assets in the cash balance plan may be more or less than the total value of the cumulative amounts in the hypothetical accounts. It is fundamental to the notion of the defined benefit plan, including the cash balance plan, that the benefit is referenced to the plan formula based on normal retirement age, not the account balance. This is the fundamental flaw in the cash balance design.

In short, the "savings account" accrual pattern that cash balance plan proponents put forward cannot operate in cash balance plans because: (1) cash balance plans are defined benefit

plans; (2) defined benefit plans do not and cannot operate in this manner; and (3) if defined benefit plans were permitted to use this type of accrual pattern, they would violate the backloading provisions of the tax laws.

Under a typical cash balance plan with a uniform allocation formula, the annual accrual – when expressed as a percentage of compensation – decreases each year an employee grows older. There is no question about how the math works: if two employees of different ages have the same compensation and the same years of service, the amount of the younger employee's annual accrual will be greater than that of the older employee.

Cash balance plans cannot have it both ways: the formula used by a cash balance plan must comply with all applicable provisions of the Code, ERISA and the ADEA for defined benefit plans – one may not substitute defined contribution rules in a defined benefit plan. Employers may not offer for analysis different formulas for calculating accruals based upon the statutory standards to be satisfied (e.g., a frontloaded formula for purposes of the Code and a "savings plan" or other backloaded formula for purposes of the ADEA). Employees – and the regulatory agencies – must demand consistency in order to determine with some accuracy the benefit to be provided in a defined benefit plan, for that is the hallmark of such plans.

VI. WEARAWAY IS AN INDEFENSIBLE CESSATION OF BENEFIT ACCRUALS BECAUSE OF AGE IN A CASH BALANCE CONVERSION

A conversion to a cash balance plan from a traditional defined benefit plan can often include a so-called wearaway period. The wearaway is an impermissible reduction or cessation in benefit accruals based on age. A wearaway is not required nor necessary in a conversion, but can occur depending on the design of the plan conversion and the opening account balance chosen by the plan sponsor. The wearaway is the direct result of the fact that the benefits earned under the old plan formula must be guaranteed and cannot be reduced. Since an employee's accrued benefit in the traditional plan remains non-forfeitable at the time of conversion to a cash balance plan, the already-earned benefit is used, in essence, to offset any new benefits for a period of time under the new plan formula.

In determining benefits under the newly established cash balance plan, some employers have chosen to use a "greater of" formula to calculate benefits. "Under the 'greater of' formula, the benefits after the amendment are initially determined under the new formula based on a participant's service both before and after the amendment date and are then compared with a 'frozen' benefit equal to the participant's benefit as of the date of amendment. If the frozen benefit is greater than the new formula benefit...the participant does not actually earn additional benefits under the plan after the amendment, because the benefit the participant ultimately receives is attributable entirely to pre-amendment service. This phenomenon is sometimes called a 'wearaway.'"[9]

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[9]See testimony of J. Mark Iwry, *supra*, at 6.

Effectively, the employee's benefit is " worn away" through the mechanism of not providing additional benefits under the new formula until the new formula benefits catch up with the frozen benefit. While age is not the only element in determining wearaway, age is a critical element in determining the amount of the frozen benefit. Because the calculation of the wearaway is based directly on age, it violates the pension accrual laws.

In amending the ADEA in 1986, Congress made it unlawful for an employer to cause any "reduction" or "cessation" in the accruals of an employee in a defined benefit pension plan "because of age." *See* 29 USC § 623(i). While the original bills were designed to outlaw the common employer practice of discontinuing pension benefit accruals upon the attainment of the normal retirement age specified in the plan (generally age 65), the final legislative language contained no such limitation and indeed was crafted to more broadly prevent the reduction or cessation of benefit accrual based on age.

The amount of wearaway, if any, is determined by an impermissible reference to age. If the plan has two similarly situated employees, both with the same years of service and same salary – with the only difference being that one is age 35 and one age 55 – the older employee will experience the larger wearaway, assuming one exists in the conversion. While salary and service may also be a component in determining a wearaway, all else being equal, age is the determining factor of the amount of wearaway. To prove age discrimination, an employee need not prove that age was the sole factor for the employer's acts, but must show that age made a difference. *See Kralman v. Illinois Dept. of Veterans' Affairs*, 23 F.3d 150, 153 (7th Cir. 1994); *Green v. Safeway Stores, Inc.*, 98 F.3d 554, 557 (10th Cir. 1996).

Since the older employee – given his closer proximity to normal retirement age – will have accrued a larger benefit based on an annuity at age 65, an opening account balance based on the actuarial value of the traditional defined benefit plan will always be larger for the older employee, all other things being equal. But for their age difference, the wearaway for two similarly situated employees would be the same. The difference is purely based on age and the actuarial arithmetic – the older the employee, and the closer to age 65, the bigger the opening account balance, and the longer the wearaway.

The following example illustrates the wearaway based on age. Assume two employees, age 35 and age 55, both with 15 years of credited service under a traditional defined benefit plan, both with a projected $1,000 monthly benefit at age 62.

IMPACT OF AGE & SERVICE ON WEAR-AWAY*

Attained Age	Credited Service	Monthly Pension Benefit at Age 62	Present Value of Pension Benefit	Cash Balance Account	Year one Wearaway Amount	Number of Years of Wearaway
35	15	1,000	$26,325	$20,041	$6,283	4
55	15	1,000	$87,582	$66,677	$20,905	8+

Source: *Poulin Associates, Inc.*
* Assumes Annual Earnings of $40,000; Normal Retirement Age of 62; Pay Credit of 5%; Salary Scale of 5%; Interest Rate of 6%; Discount Rate of 6%; Mortality According to GATT

All else being equal, the 55 year old employee will have a present value of pension benefit equal to $87,582, a cash balance account of $66,677 and a wearaway in the first year of $20,905. The older employee's benefit will effectively be frozen – with no accruals – through the normal retirement age of 62, a wearaway period that lasts at least 8 years. The younger 35 year old employee will have a present value of pension benefit equal to $26,325, a cash balance account of $20,041 and a wearaway in the first year of $6,283. Further, the wearaway period for the younger employee will last only 4 years. The difference in the wearaway is based solely on age – all else being equal. The older employee under this example will always have the longer wearaway.

VII. THE "WHIPSAW" LUMP SUM CALCULATION VIOLATES THE AGE PROHIBITIONS

The difference between the interest credit used by a cash balance plan and the discount rate required by section 417(e) of the Code to determine lump sums in a cash balance plan's formula also may discriminate against older workers solely because of their age. This so-called "whipsaw" occurs in the inherent plan formula itself, and thus can exist in a new plan or as a result of a conversion.

Many cash balance plans provide for an annual interest credit – part of the accrued benefit – that is higher than the required discount rate for determining lump sums for employees. leaving employment. For example, the plan may provide for an annual interest credit of 7 percent, but the statutory discount rate, set in Code section 417(e), may be only 6 percent. As a result, every employee in such a plan will receive a larger lump sum upon termination than the amount in the hypothetical account. However, an older employee with the same exact salary and years of service under the plan will receive a smaller lump sum than a similarly situated younger employee.

For example, assume two otherwise equal employees, one age 30 and one age 60. Assume an accumulation rate of 7% and a discount rate of 6%, thereby creating a 1% whipsaw in the employee's favor. Under this example, the projected accumulation to retirement age (at 7%) for the 30 year old is $21,353. Discounted back (at 6%), the lump sum value at that age is $2,776. For a 60 year old, the accumulation would be $2,805, and the lump sum value only $2,096. The difference in the lump sum value that each otherwise identical employee would receive is based solely on age.

Age Discriminatory Effect of Whipsaw*

Age of Participant	Accumulation to Retirement Age	Lump Sum Value at Attained Age
30	$21,353	$2,778
60	$2,805	$2,096

Source: *Poulin Associates, Inc.*
* Assumes annual earnings of $40,000; Normal Retirement Age of 65; Pay Credit of 5%; Accumulation Rate of 7%; Discount Rate of 6%

Again, the difference in the lump sum benefit is based on the projection to normal retirement age required under a defined benefit plan. The one percent spread between the plan's (in this case) higher interest credit and the law's discount rate will increase the amount of the actual lump sum (compared to the hypothetical amount, which would be the same for the two employees) based on the number of years to normal retirement age. Since the number of years to normal retirement age will always be less for the older worker, there is in essence a non-uniform subsidy based solely on age – with the younger worker always receiving a greater lump sum amount – which thus reduces the benefit based on age. Again, this practice violates the prohibition on reducing benefit accruals based on age. (Of course, should the plan's interest rate be lower than the statutory discount rate, the lump sum would be greater for the older employee. However, the age restrictions in the statute do not prohibit such a result.)

VIII. ADEA DEFENSES ARE NOT AVAILABLE TO A CHARGE OF AGE DISCRIMINATION IN A CASH BALANCE PLAN

As demonstrated, age-based reductions in accruals – both in the inherent cash balance formula and in the conversion from a traditional plan to a cash balance plan – are illegal age discrimination in violation of the ADEA, the Code, and ERISA.

Employers have sought to defend these reductions in benefit accruals by citing to various defenses available under the ADEA. Their reliance on any of these defenses is inappropriate

for a number of reasons. First, the ostensible "defenses" raised by employers to violations of the ADEA are *inapplicable to identical claims made under the corresponding sections of the Code or ERISA.* They therefore have no place in any debate (or even in litigation) relating to any reductions or cessation of accruals in cash balance plans and conversions. Second, the predictable, age-based reduction in accruals violates the explicit prohibitions of ADEA § 4(i). Congress allowed for *no exceptions or defenses* to the rule against accrual reductions in ADEA § 4(i) and its companion sections in the Code and ERISA when such reductions are based upon age. Third, these cases are clear examples of "disparate treatment" and therefore preclude the use of defenses that are applicable only to "age-neutral" practices.

XI. DISCLOSURE OF BENEFIT REDUCTION

Under current law, an employer converting to a cash balance plan must notify the plan participants as to the plan amendment. However, the employer need not describe how this amendment would impact the individual's benefits, nor how the new plan compares with benefits under the old plan formula. As a result, employees do not receive information as to the actual effect on their own plan benefits.

A number of benefit consultants have noted that one of the "advantages" of conversions is the ability to "mask" benefit reductions.[10] Many plans have chosen the route of ensuring technical compliance with the law, without regard to whether any useful information is actually communicated to employees. Obviously, the difficulty of sorting through the various plan formulas is a daunting task even to those who have sufficient information. For others, the impact cannot be discerned at all.

Plan participants who have contacted AARP generally all want to know one thing: How does this change affect <u>me</u>? AARP believes that it is essential that each affected employee be provided with a personalized statement that provides a comparison of the benefits under the old plan formula with the new plan formula. Benefits must be shown in a form that is comparable (*e.g.*, lump sum vs. lump sum, not lump sum vs. a life annuity), and such information should be provided prior to the effective date of any plan change.

Depending on the facts and circumstances of the conversion, employers may violate ERISA's fiduciary rules (ERISA § 404) by failing to properly disclose information to plan participants, and indeed, as previously mentioned, by attempting to misrepresent the consequences of the conversion.

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[10]See Ellen E. Schultz, *Actuaries Become Red-Faced Over Recorded Pension Talk*, Wall St. J., May 5, 1999.

X. POLICY CONSIDERATIONS

Proponents of cash balance plans often boast of the potential benefits that cash balance plans have over traditional defined benefit plans. In particular, because cash balance plans are "frontloaded", shorter service employees may accrue larger benefits faster.. In addition, because of the lump sum option, these amounts may be made more portable. Proponents often fail to note, however, that unless an employee satisfies the 5-year vesting period, an employee may get nothing under either a defined benefit or cash balance plan. In addition, a lump sum option could also be added to a traditional defined benefit plan if portability is the goal. (Indeed, even the increased portability may be of limited value if the lump sums are not saved for retirement. Currently about two-thirds of all lump sums are not rolled over into another retirement account.)

Some employers may desire a formula – such as the cash balance formula – that redistributes benefits from older and longer service employees to vested younger and shorter service employees. As a design for a new plan, or for new employees, some may prefer such an approach. However, the combination of both a guaranteed traditional defined benefit plan, plus a supplemental 401(k)-type plan, would be a better way to accomplish such a goal.

However, where there is a conversion from a traditional defined benefit formula to a cash balance formula (nearly all cash balance plans are the result of a conversion), there are additional consequences. Older longer service employees have been working under a plan that provided a different benefit structure – the plan provided only a small amount of benefits in the early years, but if the employee stays longer, the plan will become more generous over time. For those employees who accepted that arrangement and are now entering the more generous years, the converted plan says, in effect, never mind.

While the pension law does not mandate that benefits will continue forever, neither does it permit plans to arbitrarily reduce benefits or terminate a plan without restrictions. For example, the Code clearly prevents cutbacks in accrued benefits. In addition, a defined benefit plan that terminates must pay both income and excise taxes on any reverted assets. Clearly the Code contemplates areas where benefit promises must be kept and employers may not unjustly enrich themselves from plan assets.

Yet the shift to a cash balance formula does just that. Employees who had been promised a backloaded pension format now find that the reverse is true. As a result, employees experience often dramatic reductions in expected benefits. Worse, they experience these reductions at a time when they are closer to retirement, having made retirement plans and employment decisions based on a different benefit pattern. Those who extol the potential virtues of the cash balance format often seem to ignore or have chosen to turn their backs on those adversely affected by the conversion. Proponents defend the practice by asserting – incorrectly – that the law permits it. While many companies have recognized the losses faced by older workers and have provided various remedies to their workforce – such as permitting older workers to stay under the old plan formula – proponents do not believe workers have

any legal right to these future benefits, and that these inequities need not be addressed as a matter of public policy.

On the other hand, proponents would conveniently rather have cash balance plans treated more like defined contribution plans, with individuals receiving the amounts in their hypothetical accounts, rather than an amount based on an annuity at retirement. Yet, proponents acknowledge that cash balance plans are not defined contribution plans. The fact that the law requires defined benefit plans to be provided in the form of an annuity and that accruals are reduced on the basis of age in a cash balance formula is deemed a technicality to be circumvented, and if not, changed by law. However, proponents do not want cash balance plans treated too much like defined contribution plans, because they enjoy the funding flexibility and are unwilling to pay the income and excise taxes that a change from a defined benefit plan to a defined contribution plan normally entails.

Proponents cannot have it both ways. Proponents want cash balance plans treated as defined contribution plans for purposes of accrual rates, yet want cash balance plans treated as defined benefit plans for funding and tax purposes. Proponents side-step the adverse policy impact on older workers and offer up the law as a shield against addressing the reduction of future benefits for older workers, but raise policy concerns (and try to side-step the law) when the law governing defined benefit plans does not allow a plan to reduce benefit accruals based on age.

New cash balance plans, or cash balance plans for new employees, provide a third type of alternative to the current traditional defined benefit and defined contribution plan designs. The design of new cash balance plans – a guaranteed employer-funded benefit, protected by the PBGC, expressed as a hypothetical individual account balance, that provides greater benefits to more mobile employees – has different features than either a traditional defined benefit or defined contribution plan. But the problems for older workers caught in a conversion of a current defined benefit plan – the loss of expected future benefits after having given up benefits in the early years, the reduced rate of benefit accruals, the potential for non-accruals during wearaway periods, and the often age discriminatory feature of a whipsawed lump sum – outweighs any potential benefit of the cash balance design.

Indeed, the age discrimination laws were intended to prevent some of the very practices inherent in the cash balance plan design. The statute is very clear and specific that accruals may not be reduced because of age. The statute broadly prevents any potential age discriminatory features of plans, including any that might arise in the cash balance plan context. The statute was designed to address the harm (and, having played by the rules, the deep employee resentment) caused by cash balance conversions. If certain aspects of the cash balance alternative are to be preserved, then we must address the requirements of current law and policy to better protect older workers.

XI. PROPOPOSED REGULATORY SOLUTIONS TO IMPROPER CASH BALANCE PLAN DESIGNS

Cash balance plans can and should be brought into compliance with the age discrimination laws. To do so, their benefit accrual formulas have to be redesigned to increase – within the confines of the backloading rules – the accruals provided to older employees. The increased accruals could be derived from increases in the hypothetical allocation or the interest credit rates, thereby age-weighting the formula, or simply from the provision of additional accruals to older employees directly without disturbing the basic uniform hypothetical allocation or interest credit rate formula of the plan.

As one alternative, regulations could provide guidance to cash balance plan sponsors on the structure of age-weighted hypothetical allocation or interest credit rate formulas in the form of a safe harbor. Specifically, the cash balance plan's hypothetical allocation or interest credit rate would increase with age. The rate of increase would be the amount necessary to offset the decrease in benefit accruals that otherwise would result on account of an attainment of any age. However, the rate increase could not be so great as to cause the plan to be incapable of satisfying any of the backloading rules of section 411(b)(1)(A) through (C) of the Code. There may be different ways to structure such a safe harbor, and the Association would be open to further discussions.

Another option that has been put forward is to grandfather workers under the traditional defined benefit formula, or to give employees the choice of remaining under the old plan formula. While these options do not address the fundamental illegality of the cash balance plan design, they do address the adverse impact on older longer service workers that occur in a conversion to a cash balance plan. For that reason, a solution that includes a choice option – preferably at the time of employee termination – or "grandfather" option should also be pursued.

Other proposals have called for, in essence, splitting the plan into two parts: a pre-conversion benefit (part "A") and a post-conversion benefit (part "B"). The new benefit would then be based on an "A" plus "B" formula. Such an approach, while dealing with some issues, such as wearaway, does not deal with other issues, such as the violation of the age laws inherent in a cash balance plan. In addition, under such an approach, older longer-term employees are still faced with a significantly undervalued "A," since that part of the benefit is based on the least generous years under the old plan formula. In addition, the older worker, who is closer to the normal retirement age under the plan, will (absent any transition relief) also be facing the least generous time under the new cash balance formula. Some have suggested – as one option to improve the "A" plus "B" format – a further indexation of the benefit under "A" (e.g., for wage increases) to ensure a more consistent and fairer value under the defined benefit format. While such an approach recognizes, at least in part, the unfairness to the older worker of a cash balance plan conversion, it is generally not as generous as a "grandfather" or "choice" option.

XV. CONCLUSION

AARP appreciates the fact that this committee has begun the review of issues raised by cash balance plans themselves and the conversion of traditional plans to cash balance plans. We look forward to assisting this committee and others to ensure that these plans fully comply with the requirements of current law, and in particular the prohibitions against benefit reductions based on age. We also will continue to join efforts to ensure that the pension system delivers more adequate and secure benefits for current and future retirees.

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The CHAIRMAN. Thank you, Mr. Perkins.
Now, Ms. Ferguson.

STATEMENT OF KAREN W. FERGUSON, DIRECTOR, PENSION RIGHTS CENTER, WASHINGTON, DC

Ms. FERGUSON. Good morning, Mr. Chairman. I am Karen Ferguson, Director of the Pension Rights Center. The center is a consumer organization that has been working for the past 24 years to protect and promote the pension interests of workers and retirees. With your permission, I would like to summarize my prepared statement and submit it for the record.

The CHAIRMAN. Yes. And let me make clear that—I didn't say this ahead of time, but our normal procedure is if you have a longer statement that you have summarized in the 5 minutes allotted to you, that statement will be printed in the record in full.

Ms. FERGUSON. Mr. Bruggeman has told you how he was personally affected by cash balance conversions. He is one of hundreds of thousands of employees similarly affected. They are all, they tell us, devastated and deeply disappointed both in their companies and in the nation's private pension system.

Before this hearing, I spoke with another employee—I believe she is in the audience this afternoon—Janice Winston, a Planning Engineer with Bell Atlantic. She told me that when she learned the dollars-and-cents consequences of her company's cash balance conversion, she felt betrayed. She also felt outraged and saddened that her company would take the position that her 26 years of service were so much less valuable than the company's bottom line.

Janice was more fortunate than Mr. Bruggeman. She joined with other Bell Atlantic employees to protest the company's action, and with support from employees from other companies and the grassroots Coalition for Retirement Security, they were able to persuade their company to reverse its action.

What Janice and the other Bell Atlantic employees did took great courage. But other courageous employees have not been as fortunate. Stephen Langlie, an Engineer from St. Paul, MN, took his protest to his employer, the ONAN Corporation, to his Senator, and to the Internal Revenue Service. It took years for him to convince anyone to understand what he was saying including the Pension Rights Center. Once they understood, his company fired him. He lost both his expected pension and his job. When he filed a lawsuit, the court found that he couldn't have been fired because of his pension protest because the company had delayed so long in firing him. That of course, was because nobody had understood what he was saying.

However, his efforts convinced the IRS district office serving his area that what his company did was unlawful, and litigation is now underway.

But litigation takes a great many years, and Mr. Langlie and all of the other employees of companies who, unlike Bell Atlantic, have not reversed themselves are suffering now. It is for that reason that we were pleased to accept your invitation to talk about solutions to the cash balance conversion problem. We believe that a legislative solution can and should be developed and adopted by this Congress.

From the perspective of the employees we have been working with, there is only one solution: They should be given a choice to stay in their pre-existing plan. This is what the IBM employees over age 40 were given after they protested—or ideally, what they would really like is what the Kodak employees got: a choice at retirement age.

An alternative is the approach taken by Bell Atlantic that the employees get the better of: what they would have gotten under the old plan or the new. As employees see it, any employer that does not give choice or one of these alternatives should be deemed to have terminated their plan and be subject to the full 50 percent excise tax on any surplus assets in the plan, plus, of course, income taxes and, for Defense contractors, additional amounts payable to the Defense Department.

Although we believe the employees' position to be the right one and we are convinced that the courts will eventually find both cash balance conversions and cash balance plans to be unlawful, we are here today to suggest a compromise approach. It is an approach that reflects the reasonable expectations of both employees and employers.

The employees who have been hurt by cash balance conversions reasonably expected that their pensions would be figured by multiplying the years they worked under the plan by a percentage of their final average pay, plus a subsidized early retirement benefit. That is usually an unreduced pension payable after 30 years or after a certain period of service for example, age 55 and 15 years.

Their employers shared that expectation and funded the plans in anticipation that these "projected benefits" would be paid. They anticipated that they would pay these full amounts for all of the service that the employee had worked up to the date of the conversion.

Although the employers had, in fact, funded all of these plans for these expected benefits, they had reserved the right to change the rules of a pension plan for future years worked. Although this was almost never effectively communicated to the employees, it can be found in the fine print of the plan documents.

The compromise approach we are proposing today is spelled out in our prepared statement, but basically it does two things:

First, with respect to the years worked up to the date of the cash balance conversion, it gives the employees what they reasonably expected to receive: a pension based on the years they have worked to date, that also takes into account their final pay at the time they leave the company, plus a share of the early retirement subsidy.

Second, for the future years worked after the date of the conversion, the proposal would add to this amount the pay and interest credits provided under the new cash balance plan that are provided to all the other employees.

Employers may resist this approach because it will reduce their pension plans' surplus assets and, therefore, the earnings on that surplus that have so significantly boosted their companies income statements. As you may have noted in yesterday's *New York Times*, nearly one-third of the 30 percent increase in IBM's "operating income" last year was solely the result of increase in pension earnings.

In a letter to the editor in last week's Pensions and Investments, Jimmy Leas, an IBM attorney and engineer, noted that if you take away the one-time sale of IBM's global network to AT&T, 11.5 percent of IBM's after-tax profit and 39 percent of IBM's year-over-year profit growth are accounting rule vapor profit.

Both his letter and the *New York Times* article and earlier *Business Week* and *Barron's* articles point out that using pension income this way is extremely misleading to investors. But it is also very unfair to employees and retirees. It creates an untenable conflict of interest in which the company has no incentive to use pension surplus to increase pension benefits and every incentive to cut them back.

As corporate fiduciaries, company officials must act to increase shareholder value yet 25 years ago, in enacting ERISA, Congress determined that the money in the pension fund must be used solely in the interests of the workers and the retirees, to promote their well-being. The compromise we suggest will help further that objective.

I would be happy to answer any questions you may have.

[The prepared statement of Ms. Ferguson follows:]

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STATEMENT OF KAREN W. FERGUSON

PENSION RIGHTS CENTER

ON CASH BALANCE CONVERSIONS: PROBLEMS AND SOLUTIONS

BEFORE THE

SPECIAL COMMITTEE ON AGING

U.S. SENATE

WASHINGTON, D.C.

JUNE 5, 2000

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Mr. Chairman, Members of the Committee, I am Karen Ferguson, Director of the Pension Rights Center. The Center is the nation's only consumer organization devoted solely to protecting the pension interests of American workers, retirees and their families. Thank you for the invitation to appear here today to discuss the problems created by cash balance conversions, and proposed solutions to those problems.

PROBLEMS CREATED BY CASH BALANCE CONVERSIONS

To put today's hearing in perspective, I would like to start by noting that never in the 24-year history of the Pension Rights Center have we seen such an outpouring of employee anger, frustration and bewilderment as that occasioned by the conversion of traditional defined benefit plans to cash balance arrangements. Although the largest proportion of complaints have come from employees of Fortune 100 companies, such as IBM, Bell Atlantic, Citibank, SBC, and AT&T, we have also heard from employees in smaller organizations, including a symphony orchestra, a for-profit hospital, a nonprofit educational corporation, and a popular restaurant chain.

These employees are outraged because they thought they had a deal: If they did their part by working loyally for long years for their employer, they would get a good pension that, together with their Social Security and savings, would make it possible for them to maintain their standard

of living in retirement. They were aware that their pensions were not worth much in their early years of work, but had been assured that their plans would "pay off" as they neared retirement age. Typically, their plans had been designed so that 50 percent of their pension would be earned in their last 10 years of work. Many of these employees are highly skilled professionals who could easily have found other employment, but chose to stay because of the promised pensions.

The employees' expectations were reasonable. Their plans calculated their pensions by multiplying all of their years worked by a percentage of their pay in their final years of employment, and also typically included a subsidized early retirement provision that would allow them to leave the company well before age 65 on a full (or almost full) pension. Instead, as the result of a cash balance conversion, they will get pensions, which, in many cases, are worth hundreds of thousands of dollars less.

It is important to note that the employees' understanding of "the deal" was shared equally by their employers. The companies funded their pension plans with the expectation that a significant portion of their workforce would retire at a time when their salaries were much higher, and with an early retirement subsidy. To our knowledge all of these plans were funded to assure that they would be able to pay these "projected" benefit obligations.

As employees see it, their employers reneged on the deal by converting their plans to cash balance formulas. In some instances the conversion occurred shortly after a takeover or the advent of a new management team, but, whatever the circumstance -- and whatever the rhetoric accompanying the change -- the result was an immediate and substantial saving on pension costs that significantly boosted their companies' bottom line. Put simply, the employees feel betrayed.

Employers defend their actions by contending that cash balance plans are better designed for today's highly mobile workforce, provide higher benefits at earlier ages relative to defined

benefit plans, and are portable and easier to understand by employees who are accustomed to the simplicity of individual savings accounts. Employers contend that with the booming economy, cash balance plans are necessary to attract new workers. They also say that with a shrinking workforce, they no longer need to offer subsidized early retirement benefits -- the most important feature of traditional plans for many large companies -- because they do not want to encourage older workers to leave.

In fact, these claims do not pass muster. Certainly, career-average formulas may be better for many younger workers, but adoption of these formulas need not be at the expense of mid-career and older workers. To our knowledge, all of the companies that have switched to cash balance plans had pre-funded their plans in anticipation of paying larger benefits to these workers.

In addition, overfunded traditional plans can easily provide portability and increased accruals to assure that younger employees get meaningful benefits. With millions, and in many cases billions, of dollars in pension surpluses, virtually all of these employers could easily provide significant enhancements to their benefit formulas for younger workers — and allow terminating employees to take lump sums. Moreover, traditional plans could be made to look more like individual account arrangements simply by disclosing the present lump sum value of benefits to employees.

In implementing cash balance plans, it is employers, not the employees, who get the benefit. They get the simplicity, flexibility, and low costs of an individual account plan, while at the same time providing employees extremely small contributions that in most cases are fully paid for by the surplus from the pre-existing plan and stock market returns that far exceed the meager amounts they have promised.

Companies argue that employees are better off under these plans than if they simply

terminated and set up 401(k) plans because the employer takes the risk. But, we ask, what risk? If the stock market plummets, employers can simply reduce their promised contribution under the cash balance plan, or terminate the plan altogether.

We have already begun to see companies that converted to cash balance plans reducing their contributions. According to employees, MCI, which converted to a cash balance plan a number of years ago has now eliminated all of its contributions to the plan, and only provides interest credits. The company explained that, instead, it was improving its 401(k) plan. Not mentioned is the fact that the improvements to the 401(k) will benefit only those employees who can afford to voluntarily contribute to the plan.

As for the benefits of cash balance plans for young, mobile workers, almost all cash balance plans have five-year vesting. Yet according to the Labor Department, the median job tenure for workers aged 25 to 34 is just 2.7 years and many young people will hold as many as nine jobs by the time they're 32. A December 16, 1999 *Wall Street Journal* article notes that this rapid turnover combines with five-year vesting to prevent countless younger employees from gaining any benefit at all from cash balance plans. The article points out that 57 percent of employees in the MCI cash balance plan left before they were vested.

In addition, those younger workers who stay until they are vested, will get extremely small amounts since cash balance plans are typically weighted for age, with young employees receiving extremely small pay credits.

Then there is the employers' claim that they need to eliminate subsidized early retirement benefits in order to encourage employees to remain with the company. This is also suspect. The reports we receive from mid-career and older employees working for companies that have converted to cash balance plans suggest that employers have little interest in retaining older

employees. Rather, the companies no longer feel that they have to provide early retirement packages to "ease" the employees out. After cash balance conversions, some older employees earn so little, if anything, in future benefits, that they conclude that it is no longer worth their while to stay. Those who can find other jobs, leave. If employers really wanted to retain older employees, they could use pension surpluses to offer a variety of incentives, among them, increased benefit levels and cost of living adjustments when they retire.

Finally, although employers argue that cash balance plans are superior to 401(k) plans, there is a very real possibility that these are just "way stations," on the road to total reliance on individual savings plans. If true, this would be very disconcerting since government figures show that 401(k)s continue to be used primarily for non-retirement purposes, and by better-off employees. According to the 1998 Survey of Consumer Finances, the median account balance for 401(k)s was only $15,000.

PROPOSED SOLUTIONS TO CASH BALANCE CONVERSION PROBLEMS

First, we strongly believe that no legislative "solution" to cash balance conversion problems should interfere with litigation and age discrimination complaints that have already been filed. Employers knew full well that their actions were unlawful, and simply counted on the fact that they were "too big to fail." Since all of the plans that have been challenged have ample surplus assets, they can readily settle these complaints, before the agencies and courts rule, by offering current employees the choice to go back under the prior plan, and restoring pension losses to those employees who left the plan as a result of the conversion.

Second, we believe that any legislative proposals should include the following three components:

- **An option for employers to offer their employees a choice between their pre-existing plan and the cash balance plan (or the "better of" the two plans);**

- **Alternative provisions that will assure that conversions meet minimum requirements designed to fulfill the reasonable expectations of employees and employers;**

- **Clarification that conversions that fail to provide "choice" or to satisfy the minimum requirements will be considered to be plan terminations, subjecting any reversion to full excise taxes.**

I. Incentives to Encourage Employers to Choose Choice.

In our view, any legislative proposal should provide an option to employers to "do the right thing," namely, offer employees the right to choose to stay under their old plan (and, ideally, require that the choice not be made until retirement age), or give them the better of the benefits under the old and the new plans. Fortunately, this is what a growing number of employers are already doing. These "best practices" should be encouraged.

II. An Alternative to Fulfill "Reasonable Expectations" of Employees and Employers.

From the vantage point most of the affected employees, "choice" or a "better-of" formula are the only acceptable options. However, in the interest of resolving this extremely contentious issue expeditiously, before more employees are hurt, we propose a compromise alternative.

This fall-back approach would assure that employees would receive the equivalent of the full benefits they had counted on getting under the old formula *for the work they have performed as of the date of the cash balance conversion,* to the extent that the plan has sufficient funds at the time of the conversion to pay for these benefits, plus full benefits under the cash balance plan for future years of work.

This approach reflects the fact that, as noted above, until the advent of cash balance conversions, mid-career and older employees in most traditional defined benefit plans reasonably

anticipated that if their company remained profitable, and if they kept working, and if the pension plan had ample funds to pay promised benefits, that they would be paid unreduced (or substantially unreduced) benefits at early retirement age, if they met specified age and service requirements, and that they would receive benefits that would be calculated on the basis of their earnings at the time they left the company. At the same time, it incorporates the employers' expectations that they could change the rules at any time for any work performed in the future. This alternative proposal is extremely simple in concept, but complicated to explain. It has four parts.

Part one assures that opening account balances in cash balance plans will be calculated fairly. It proposes using a single statutorily prescribed interest rate to convert the employees' annuities under the old plan into "hypothetical" opening account balances.[1]

Part two of the proposal addresses the expectation of many mid-career and older employees that they will receive subsidized benefits at early retirement age (or after a specified period of service).

Under current rules, if a cash balance conversion occurs before employees meet the requirements of a subsidized early retirement pension, and the employees subsequently satisfy those requirements, the employees' lifetime monthly pensions must be "bumped up" to reflect the pro rata share of the subsidy that the employees have earned as of the date of the conversion. If, however, the employees' benefits are paid as lump sums, the subsidy can be forfeited. This can result in the loss of up to 60 percent of the value of their pensions.

The proposal addresses this problem by building on a long-standing tax code principle

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1 It is necessary to do the "hypothetical" conversion because all pay credits and interest under the new cash balance plan will be added to this amount. However, the amount is only "hypothetical" because the benefits under the old plan will be paid out as an annuity if this was the normal form of benefits under the plan (or the form selected by the employee).

designed to deter employers from amending plans for the purpose of increasing the amount of surplus assets in their plans that could potentially revert to them. It would require the "vesting" of a pro rata share of the early retirement subsidy on the date of the conversion, to the extent that there are sufficient funds in the plan to pay these amounts. These amounts would then be added to the "hypothetical" cash balance accounts.2

Part three of our proposal addresses the employees' expectation that they would receive pensions based on their earnings at the time they left the company. It has three stages:

- In stage one, the employers would be required to calculate the employees' hypothetical opening account balances on the basis of their pay at the time of the conversion.
- At stage two, when the employee retired, there would be a recalculation, based on any increase in pay (for the service performed at the time of the conversion).
- The third stage would entail retroactively crediting contributions (and compounding interest) on the difference between the opening account balance and the balance as recalculated at retirement.3

Part four of this alternative proposal would require that the employers begin adding pay and interest credits to the "hypothetical" opening cash balance accounts immediately after the conversion, at rates that do not discriminate against older employees.

III. Clarification that the full reversion excise tax applies, if these rules are not followed.

If employers opt not to allow their mid-career and older employees to stay in their old plan until retirement age, and/or provide them with roughly equivalent benefits under the cash balance

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2 This would provide a financial incentive to employers to offer their mid-career and older employees the choice of staying under the old plan since, by giving the pro-rata share of the subsidy to all employees (not just to those who later meet the age and service requirements), would increase costs above those originally projected for the subsidy.

3 To assure that sufficient funds would be available, plans would be required to spin off the amounts projected to be needed for this purpose at the time of the conversion. These funds could either be added to the trust being used to pay

plan, the pre-existing plan has plainly terminated with respect to these employees, and the full 50 percent reversion excise tax should be imposed on any surplus assets.

There are, of course, other legislative measures that should be considered. They include proposals to address problems of inadequate disclosure and, most important, the untenable conflict of interest situation created by Financial Accounting Standard Board's Rule 87 — which we think poses the most serious threat to date to the future of the defined benefit system. I would be pleased to discuss this all-important issue in the question period. Thank you.

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participants who retired before the conversion, or segregated in a separate trust. Any shortfalls would be made up by the employers; any excess would be allocated among post-conversion participants.

The CHAIRMAN. Thank you very much to all of you for your fine testimony, and particularly for your suggestions of changes to be made.

I am going to ask each one of you specific questions, but if anyone has a rebuttal or addition that they want to make beyond what the one person says, it is OK to chime in. And so I will start with you, Mr. Bruggeman.

What was your old plan like? And did you have a 401(k) type plan?

Mr. BRUGGEMAN. The old pension plan was a defined benefit plan. It did have a 401(k) plan in addition to it to make up the total retirement package. The 401(k) plan, the old 401(k) plan, provided for a company match of up to 6 percent of the employee's salary, the match being 50 cents on the dollar for up to 20 years of service, and after 20 years of service, 75 cents on the dollar.

That plan was enhanced when the new pension plan was made effective. What it did was it provided for a 75-cent-per-dollar match up to 6 percent of salary for all employees. So you did not have to accumulate the 20 years to get the 75-cent match.

Of course, in my case and many other employees who already had the 20 years of service, this enhancement did not provide us any benefit at all. And as a matter of fact, it provides a small increment of benefit as compared to the drastic reduction in the pension plan itself.

The CHAIRMAN. My next question was to ask you about your new cash balance plan. Does that describe it? Or do you have a further description?

Mr. BRUGGEMAN. The new cash balance plan begins with a beginning balance. That beginning balance is determined by present valuing the expected benefits that you would have if you retired at age 65. So the beginning balance, of course, does not have any early retirement subsidies in it.

The beginning balance also for my employer and for me is less than what I have earned by law under the old plan.

The CHAIRMAN. OK. In your testimony, you mentioned that the IBEW asked the company to run some calculations. Are you a member of the union or are you a member of management?

Mr. BRUGGEMAN. I am a member of management. I am not a member of the union.

The CHAIRMAN. OK. When did you first discover the problem with your plan?

Mr. BRUGGEMAN. I first discovered the problems in the spring of 1997. The new plan became effective in July 1997. The company had provided some training programs or informational type programs, and I became very interested in how the benefits under the new plan compared to my benefits under the prior plan.

The CHAIRMAN. Did you ask for redress from your problems? And if so, what was the answer that you got?

Mr. BRUGGEMAN. Yes, on several occasions, I asked the company to look at the fact that the benefits had been reduced so drastically. In my case, I mentioned they were 30 percent, and many employees over 40 years of age in our company, the benefits were reduced 30 to 50 percent and in some cases even more than 50 percent. So not only for myself but other employees, these benefit reductions

were so great, I did bring up the subject with the company. I was told to not talk to any employee about the benefit reductions because it might cause an uprising or a class action suit. I was told to put it away, forget about it, don't bring it up again. I was told that my employment could be subject to my continuing raising questions about the pension plans.

Those comments were from my supervisor. The comments that I received from the Human Resources Department were: There is no use of you bringing up any questions about the plan; it has already been approved by the board, and we are not going to change it.

Many times I was not given a response at all to a question. I was told that it takes too much of Human Resource's time to answer my questions.

That pretty well summarizes it.

The CHAIRMAN. Do you know how many—maybe I should say, just roughly, do you know how many employees are in the same situation you are?

Mr. BRUGGEMAN. Yes, I do. Central and South West at the time of the benefit change had about 7,500 employees. Now, 80 percent of those employees were affected by the new plan, about 6,000 employees.

The CHAIRMAN. And by "affected," you mean negatively?

Mr. BRUGGEMAN. Affected negatively, yes, sir. The other 20 percent were not affected because they had a choice between the old plan and the new plan. They were given a choice. If you were 50 years of age and had at least 10 years of service at the time of the plan change, you were grandfathered under the old plan. But the employees that were not grandfathered were all affected, some affected more than others. The employees between 40 and 50 years of age were affected more than younger employees; however, these younger employees were very significantly affected, also.

The CHAIRMAN. Have you calculated how long you have to work to make up what you figure you lost?

Mr. BRUGGEMAN. Yes, I have. I would have to work an additional 6 or 7 years to have a benefit of the same dollar amount per year as under the old plan had I retired earlier.

The CHAIRMAN. What percentage of your reduction in your future benefit is attributable to the discontinuation of the subsidized early retirement benefit?

Mr. BRUGGEMAN. If I decide to take the frozen benefit, it does include the early retirement subsidies, as I pointed out before. However, the lump sum under the cash balance can be as much as 50 percent less than the true equivalent to the frozen benefit, or the benefit under the old plan.

So by not including the early retirement subsidies, the cash balance is a very inferior number as compared to the frozen benefit.

The CHAIRMAN. OK. Now, Mr. Perkins, I would like to read a couple of quotes to you and ask you to comment on them. They are from an article that appeared in the May 31, 1999, issue of Pensions and Investments, and it is a quote from one of the witnesses on the next panel, Dr. Schieber. "One of the motivations to move to cash balance plans is they do provide cost savings."

And here is a quote from an article that appeared in the Washington Post entitled "Attacking Pension Coverage," and this is Feb-

ruary 20, 2000, again quoting Dr. Schieber: "They said they wanted to cut costs and, by golly, they did." Now, that is what I want your comments on, those two articles.

Mr. PERKINS. Certainly cost was the key factor, we believe, in the institution of cash benefit pension systems, but it is not the only factor. Even if costs are neutral, there is a redistribution from older to younger workers and longer-service workers to newer, younger workers which is adverse.

It is almost as if because of the spike, so to speak, that happens in a traditional defined benefit pension plan, whereby your later years give you a greater value as a result of increase in final average pay years, that the person is adversely affected it is not just the cost question. It is the question whether the people get the worst of both packages or both plans. They get the worst of the traditional pension plan that is frozen at that time and the worst of the cash pension benefit plan because they are in their later years.

So cost is a factor, but it is not the only factor, very definitely.

The CHAIRMAN. You stated, again, Mr. Perkins, that the ADEA, or the Age Discrimination Act, prohibits age discrimination in benefit accruals and that the ADEA defenses are not available to a charge of age discrimination in cash balance plans; therefore, you believe that the cash balance plan design is age discriminatory.

Do you believe that it is age discriminatory?

Mr. PERKINS. Yes, we do. We do believe that, Senator Grassley. When you look at some charts that have been presented in one written statement it demonstrates that the wearaway creates a situation in which a person may have a number of years of service for which they do not get any accrual at all until there is a catch-up to what the frozen amount was. We feel that is age discrimination. Also, the fact that even though the accrual dollars, regardless of the wearaway, or after the wearaway period is over, might appear to be the same, we do know that because of reduced time for interest accrual on those dollars there is very definitely for an older employee less accumulation than there would be if the employee was younger.

The CHAIRMAN. Do you believe that cash balance plans *per se* violate the ADEA?

Mr. PERKINS. We are quite certainly raising that as a question based on the actual age discrimination laws that are in existence.

The CHAIRMAN. Now, I want to follow up on that with you, Ms. Ferguson, whether or not you would agree that they are a *per se* violation.

Ms. FERGUSON. Yes, I would agree. I just actually happened yesterday to read an excellent article in the January 1999 issue of *Tax Notes*, called "The Down-Aging of Pensions," which I would like to submit for the record because I think it spells out as well as anything else exactly why cash balance plans by design violate the age discrimination laws.

It is important to note that employers did these cash balance conversions relying on a very technical reading of certain provisions of the pension and tax laws. The argument that the plans by design violate the age discrimination rules is equally technical, but it is supported by the plain language of the law, just as they claim arguments are.

The CHAIRMAN. Then I want to ask both Mr. Perkins and Ms. Ferguson whether or not you believe that the cost-of-living adjustment that commences before normal retirement age is inherently age discriminatory.

Mr. PERKINS. When you mention the cost-of-living adjustment, do you mean before I retire, the fact—when you say that, what cost of living adjustment, to the pension?

The CHAIRMAN. Yes, I——

Mr. PERKINS. The final average pay goes up based on cost of living.

The CHAIRMAN. We are only talking about if the plan requires that that be added.

Mr. PERKINS. I think that you are somewhat alluding to one of the situations we put forward. If the frozen benefit upon conversion was indexed according to cost of living or some similar index, so that up to age 65 it would be like an indexed portabile pension, then there would be a question. And we do mention that in our formal statement. And then the Part B would be—that first indexed benefit would be what we call Part A—the Part B would be what the person continuing in the cash pension plan receives.

But the worry there is still where is the wearaway. Is there still a wearaway at that point in time? But we do raise that question as a situation to be looked into.

The CHAIRMAN. OK. But you are not then right now saying that that aspect is age discriminatory?

Mr. PERKINS. If the frozen benefit is indexed for that person to age 65, that raises a question that we want to look at, and we are willing to look at that. But it doesn't—we are not making any——

The CHAIRMAN. Your comment on my question, not just—well, it can also be on his as well. But I wanted to—the question is to both of you, not just your commenting on his. You can do that as well, but I want to know if you feel that it is inherently age discriminatory.

Ms. FERGUSON. I am not quite sure that I understand the question. It may arise out of the recommendations of AARP.

Mr. PERKINS. We have a paragraph in our formal statement which talks about splitting the plan into two parts, which I mentioned. Part A would be taking the frozen, traditional defined benefit pension and indexing it such so that it would be increased in size based on the way it would be if the person had continued work. The only thing is, of course, the number of years stays the same. If you assume that the person would have a greater income, the only thing you are gaining is the cost-of-living adjustment. And then the Part B would be the post-conversion benefit, which would be the cash benefit—the cash pension benefit plan.

And while such an approached recognizes, at least in part, the unfairness to the older worker, it is generally not as generous, of course, as grandfathering or a choice option.

The CHAIRMAN. Well, let me follow it up, then, with this which is somewhat connected but leads us one step further. I want to know if there is something here that can be fixed or if we are wasting our time. Is it your position that cash balance plans are illegal and should be required to unconvert?

Mr. PERKINS. We very definitely worry about the conversions. In fact, all cash benefit plans have been conversions. We worry about the fact that the older worker does get the worst part of both deals. And, very definitely, in our formal remarks and in my statement, I did mention that some of the remedies, or compromises, could include grandfathering options. We definitely also want to talk about disclosure, so, therefore, a person will know what they are getting. But with the options available and good grandfathering procedures. It appears looking at your chart as to what has happened to the pension benefit systems, that no DB plans have been devised in the last number of years.

The CHAIRMAN. You say that almost every aspect of cash balance plans is illegal—wearaway, the fact that the workers closer to retirement have less time until they reach normal retirement age to accrue benefits than younger workers. So many aspects of the plans are illegal. Aren't they illegal as well?

Mr. PERKINS. Would you repeat the portion, what are the portions that are illegal, sir?

The CHAIRMAN. Well, I was speaking specifically about the wearaway.

Mr. PERKINS. Yes, go ahead.

The CHAIRMAN. Well, I just described that. And so you get a lot of the aspects of the plans that are illegal. To what extent does that, in your judgment, then make the total plan illegal?

Mr. PERKINS. Well, certainly wearaway is a situation we have great concern about and there are other aspects of the plans that we question. But basically it is the unfairness to the older worker that is our concern. It remains our concern, and we want to remedy unfairness for employees such as Mr. Bruggeman and all the other thousands of employees around the country.

One of the things that is interesting is that cash balance plans are more understandable, admittedly, than traditional defined benefit plans, and as a result, many of the workers realize that and are raising questions concerning the inequities to older workers compared to younger workers.

So that is a concern we have, sir.

The CHAIRMAN. Ms. Ferguson, from your statement, you also seem to believe that cash balance plans are illegal, though you say everything but that they are *per se* discriminatory. It may be pushing a little bit hard, but what is your bottom line on this point? Are they *per se* discriminatory?

Ms. FERGUSON. Yes, they are per se discriminatory. However, our reason for wanting to testify today and being so pleased that you are holding this hearing is that we do believe that without affecting any of the complaints that have been filed in court or with the administrative agencies, Congress is in a position to fashion a solution to this problem that can take into account those concerns of employers that are legitimate and those concerns of employees that are legitimate.

It seems to us that that is what we should be doing, focusing on getting the parties together and developing a realistic solution.

The one good thing that has come out of this whole controversy over cash balance plans is that employers and employees alike are recognizing the critical importance of pensions, and specifically, the

critical importance of employer-paid pensions where employers take the risk.

The argument you see over and over again by the employers and their consultants is, the cash balance plan is better than a 401(k) because, so many employees can't afford to take advantage of the 401(k) and get the match. And, in fact, the most recent Government figures show—and there is an error in my prepared statement on this—the median account balance for 401(k) type plans is only $15,000. We cannot expect a voluntary, do-it-yourself savings program to provide the supplement that employees need to add to their Social Security payments. They need pensions. And employers in their defense of cash balance plans, are saying exactly that. Employees need employer-paid plans, and they need plans where the employers assume the investment risk. That is good, and I think we can fashion a proposal that addresses that and recognizes the importance of pensions.

The CHAIRMAN. I don't know whether you have said that this is both an issue that Congress ought to deal with, or that each individual plan ought to deal with between the employees and the employers or it ought to be one or the other.

Ms. FERGUSON. The more fronts, the better. We have seen that the IBM employees got 300 million votes in favor of their shareholder resolution to provide choice to all employees.

If Congress could move expeditiously by preserving the rights of those people who have already filed litigation——

The CHAIRMAN. You know Congress can't move expeditiously.

Ms. FERGUSON. That would be the ideal front. I think we should move on all fronts.

The CHAIRMAN. I am trying to understand your proposal. You seem to say that somehow or another a plan participant should not experience any decline in their expected benefits when they get to retirement age, so the sponsor should make the cash balance plan at least as generous as the traditional defined benefit plan. Is that more or less correct?

Ms. FERGUSON. No. That is what the employees want. We are in sort of a unique position here of coming forward to offer compromise that the employers might also accept. That compromise says that only with respect to the years the employees have worked up to the date of the conversion, should they be given what they reasonably expected and what the employer funded for. What they reasonably expected was that the years they worked up to the date of conversion, be figured on what their pay is when they finally leave the company.

Now, that adds a bit of complexity, but I believe Boeing did exactly that. In addition, to the extent that they have relied on receiving an early retirement subsidy, they should get a pro rata share of that. That is perfectly consistent with longstanding tax principles. It is not easy to explain. It is much simpler to give choice.

Then, as long as they get the full value of the pensions they have earned as of the date of the conversion, the second half is simply to add to that exactly what the other employees, the employees under the cash balance plan are getting in the way of future pay credits and future interest credits.

The CHAIRMAN. You said that the principal reason for the conversion to a cash balance plan is to save pension costs. Couldn't a plan sponsor save a lot of money simply by discontinuing early retirement subsidies? That would have had nearly the same effect as the conversion, but the sponsor would not have to notify plan participants under ERISA Section 204(h).

Ms. FERGUSON. It would not save quite as much. They would have to give a pro rata share of the subsidy when the employees reached the 30 years, let's say. They would not save as much. They would also not save the final pay bump-up.

The employers could do that. The reason they are not terminating the plan is, of course, very simple—to well, for two reasons: first, to avoid the reversion—that would be arguably deemed a horizontal partial termination. They are trying to avoid the taxes that would be imposed if it were deemed a full termination.

The CHAIRMAN. But isn't it likely that the cash balance arrangements could pay richer benefits to short-service vested workers? And what if some short-service vested workers are 40, 50, or even 60 and they can earn richer benefits under the cash balance plan? What would you do then?

Ms. FERGUSON. Well, there are certainly younger shorter-service employees who will do better under the cash balance plan. As Mr. Perkins said, what is going on here is a redistribution from older to younger workers.

But I think it is very important to note a couple of points. There has been a lot of talk by employers about how well younger, shorter-service workers are going to do under these plans. But, in fact, you have to work 5 years in order to earn anything under these plans, and the median job tenure for younger workers is only 2.7 years.

Second, these plans, just like traditional plans, are typically weighted——

The CHAIRMAN. Under that circumstance? They are no worse off than under the traditional plan.

Ms. FERGUSON. Absolutely. But the idea of saying that we are doing this because we want to attract younger workers doesn't quite compute, as they say.

But the further factor—and I think it is important and very little known—is that cash balance plans can be and many are weighted, just the way traditional plans are, in favor of higher paid and older employees. They are integrated with Social Security, and they are backloaded, age-weighted. In fact, the younger employees are going to get very, very little. Overall the contributions to these cash balance plans are very small. They depend very heavily on being supplemented by a 401(k). And, of course, that depends on the employee's ability to contribute, and that isn't, to our understanding, working.

So the cash balance plans, the good thing about them is that they are employer-paid and they are insured by the Pension Benefit Guaranty Corporation and the employer assumes the investment risk. But they are not as good as many employers seem to be suggesting.

The CHAIRMAN. You have suggested that sponsors who convert to a cash balance plan should have to meet certain additional funding

requirements in order to avoid being charged an excise tax on the excess assets in the plan. Is that more or less your position?

Ms. FERGUSON. What we are saying is that if the employer chooses not to offer choice or not to accept the kind of compromise proposal that I described, then the ordinary penalties for terminating a plan would come into play.

These are really plan terminations. The employers talk about their old plan and their new plan. It is only through a very technical glitch in the law that they are able to say that these are continuing plans.

The CHAIRMAN. I think based on what you said, I want to ask: What about a plan that is an underfunded cash balance plan? They could convert and no such penalty would apply?

Ms. FERGUSON. That is current law, yes.

The CHAIRMAN. Now, let me quote from page 2 of your testimony. "Plans were funded to assure that they would be able to pay these projected benefits." What do you mean by that? And do you mean benefits under the plan upon retirement? Because plans are not allowed to fund for projected benefits.

Ms. FERGUSON. Employers do fund for projected benefits to the extent they are able. That is what actuaries recommend. They have bumped into—and Dr. Schieber will be talking about that, I am sure, on the next panel. They have bumped into problems created in the late 1980's when Congress was very concerned, and the accounting profession was very concerned, that companies were stuffing money into their plans and then pulling it out when it was convenient for them for tax reasons. And both the accounting profession and Congress put in place rules which, I agree, probably should be reconsidered. But right now, yes, they do fund for these benefits.

The CHAIRMAN. I have no further questions, and other members have not come or weren't able to come today. For 2 weeks I would like to leave the record open for you to receive questions from me or from other members who couldn't be here. So I hope you would respond to those in writing. Any final comments by any of you before I call the second panel? [No response.]

OK. Then I thank you all very much for your cooperation.

On our second panel, we will hear from Central and South West Corporation, Ms. Laurel Sweatt, the Manager of benefits, will testify. She is appearing, though, on behalf of the Association of Private Pension and Welfare Plans.

Then we will hear from Dr. Sylvester Schieber, the Director of the Research and Information Center for Watson Wyatt Worldwide. Dr. Schieber is probably best known for his scholarly work on Social Security. Today he will discuss his exhaustive research, an analysis of data on cash balance plans and traditional defined benefit plans and their participants. And we have accompanying Dr. Schieber, Mr. Eric Lofgren. If he wants to be at the table, you can have him at the table.

Then, finally, we have Mr. John Woyke, who is Principal with the firm of Towers Perrin in New York. Mr. Woyke has over 30 years experience in employee benefits. He is a Tax Attorney and an Enrolled Actuary. He will be representing the U.S. Chamber of

Commerce. I welcome all of you. And if I mispronounced any names, let me know.

We will start with you, Ms. Sweatt.

STATEMENT OF LAUREL SWEATT, MANAGER OF BENEFITS, CENTRAL AND SOUTH WEST CORPORATION, DALLAS, TX, REPRESENTING THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Ms. SWEATT. Thank you, Mr. Chairman, for the opportunity to appear today. I am Laurel Sweatt, Manager of benefits for Central and South West Corporation. CSW is a Dallas-based global energy services business. I am also here today representing the APPWP-The Benefits Association.

The discussion about cash balance plans must be placed in the context of our defined benefit pension system. Defined plans place funding responsibility and investment risk on employers and offer insured benefits, providing meaningful retirement security. Yet since 1985, as you have pointed out, the number of defined benefit plans insured by the PBGC has dropped from 114,000 to 44,000, as our chart over here shows, due in substantial part to over-legislation and over-regulation. Cash balance defined benefit plans have been the one hopeful sign amid this increasing trend toward plan terminations.

CSW converted to a cash balance and increased its defined contribution plan match in July 1997. Prior to these changes, a team of CSW employees were asked to evaluate our existing retirement plans and determine whether they were meeting employee and our business needs. The team discovered that the value provided by our defined benefit plan was significantly higher than that of other companies. This was largely due, in fact, to a cost-of-living adjustment that was offered by less than 2 percent of the Fortune 500. The team also found that the value provided by our defined contribution plan was significantly under the norm.

Instead of simply bringing these plans in line with the benchmarks, the team looked for additional ways to develop value for our employees. They found that the cash balance plan met this need by being easy to understand, providing immediate payment options, and expanding our benefits for our beneficiaries.

CSW received a favorable determination letter from the IRS for our retirement plan changes in August 1999. Our purpose in converting to a cash balance plan was not primarily to save money. While the conversion did create expense savings, primarily as a result of eliminating our cost-of-living adjustment, our cash costs since 1998 have been higher than before, and we anticipate this to continue.

Let me mention a few of the steps that CSW took to minimize the detrimental impact on our employees.

First, we used a lower-than-market interest rate in converting employees' benefits to lump sums. This created higher opening account balances.

Second, we added 13 percent of base pay to the accounts of employees age 40 and over with 5 or more years of service.

And, third, we gave employees age 50 and over with 10 or more years of service a choice.

Less than 2 percent of our employees were expected to experience a wearaway as a result of our conversion.

APPWP believes that the appropriate legislative response to the concerns that have been raised about cash balance conversions is to enhance the disclosure requirements. The most effective way to provide this additional information is through an extensive set of illustrative examples that demonstrate how representative types of employees will fare relative to the old plan. These extensive examples would illustrate the effects of the conversion on workers of different tenure, age, and pay at different future dates.

We believe that individualized benefit comparisons would be only marginally more useful to employees than these extensive illustrative examples. Moreover, the difficulties associated with translating this ideal of personalized information into the real world of plan administration are truly extraordinary.

APPWP believes banning the benefit plateaus known as wearaway would be an extremely counterproductive step. Benefits plateaus have been expressly approved under the law for many years. A plateau prohibition would prevent constructive plan changes, complicate pension administration, and lead to benefit reductions for some workers.

Mr. Chairman, the claims that cash balance plans and conversions are age discriminatory are conceptually flawed and legally incorrect. Conceptually, the charge that the cash balance design is discriminatory produces a distinction without substance between 401(k) and cash balance plans, both of which provide the same contribution rate for all workers. Legally, the rate of an employee's benefit accrual that cannot decrease because of age refers to the accrual rate spelled out in the plan. For cash balance plans, this is the rate of contributions to the employee's account which does not decrease with age.

Some charge that older workers have the longest benefit plateau periods, resulting in age discrimination. Yet the length of the plateau period is predominantly a function of service and pay rather than age. The law makes clear that a benefit plateau based on a factor such as length of service that generally correlates with age does not constitute discrimination.

In closing, APPWP recommends narrowly crafted disclosure reform as the appropriate policy response to cash balance conversions. We commit to work with you to enact practical disclosure legislation that will provide employees with the information that they need. We hope that Congress will avoid the benefit mandates that would undercut our joint efforts to expand pension coverage.

Thank you for the opportunity to appear.

[The prepared statement of Ms. Sweatt follows:]

The Benefits Association

APPWP

Association of Private Pension and Welfare Plans

Testimony of Laurel Sweatt
Manager of Benefits
Central and South West Corporation
Dallas, Texas

On Behalf of
The Association of Private Pension and Welfare Plans
(APPWP - The Benefits Association)

Before the
Special Committee on Aging
United States Senate

Washington, D.C.
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Good morning and thank you, Mr. Chairman, for the opportunity to appear today. I am Laurel Sweatt, and I am the Manager of Benefits for the Central and South West Corporation. Central and South West Corporation (CSW) is a Dallas-based public utility holding company that owns four U.S. electric utility subsidiaries with 1.8 million customers, a regional electricity company serving 2 million customers in the United Kingdom, and non-utility subsidiaries involved in energy-related investments, as well as subsidiaries that offer telecommunications, energy efficiency and financial transaction services. American Electric Power of Columbus, Ohio and CSW announced their intention to merge on Dec. 22, 1997. The merger will create a company with approximately 38,000 megawatts of generating capacity in the United States, more than 4.7 million customers in 11 states and approximately 4 million customers outside the U.S.

I am also here this afternoon representing APPWP – The Benefits Association. APPWP is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, APPWP's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

I will begin my remarks this afternoon with a discussion of the state of our defined benefit pension system. Cash balance plans are defined benefit plans, and both these plans and the legislative initiatives they have generated should be evaluated in the context of our defined benefit system as a whole. I will next turn briefly to the reasons employers have moved to cash balance and other hybrid designs as well as to companies' efforts to address the needs of longer-service workers during these transitions. I will then discuss our specific conversion experience at Central and South West. The remainder of my remarks will be devoted primarily to a discussion of the various legislative proposals concerning cash balance plans. I will conclude with some brief remarks about the age discrimination issues that have been raised in connection with cash balance plans and conversions.

The Defined Benefit Plan Context

In APPWP's view, the discussion about cash balance plans should be placed in the context of the defined benefit pension system as a whole. APPWP's member companies believe that defined benefit plans continue to play an important role in America's retirement system. These plans place funding responsibility and investment risk on employers, insure benefits through the Pension Benefit Guaranty Corporation (PBGC), and provide annuitized lifetime benefit options. These features add up to meaningful retirement security for America's working families and have led many policymakers in the Administration and in Congress to champion defined benefit plans. Nevertheless, our defined benefit system is in decline.

While not always the case, traditional defined benefit plans are often underappreciated and misunderstood by employees. For example, in an internal employee survey performed by one of APPWP's member companies, the *employee fitness center* was rated as a more valuable benefit than the traditional defined benefit pension plan. As you can imagine, the fitness center is vastly less expensive and less complicated to operate than the pension plan. In many instances, traditional final average pay defined benefit plans also provide limited incentive and security to employees in an economy where the average duration of an individual's tenure

with a firm is only 3.6 years. This abbreviated tenure is also reflected in the interest of many employees in "short-horizon" benefits, such as 401(k) plans, health insurance, stock options, and cafeteria plans. Employers need to reassess the use of benefit dollars that are providing benefits that are underappreciated by large groups of their employees. Moreover, defined benefit plans have been over-legislated and over-regulated. Plans and administrative practices must be constantly adjusted to reflect these annual legislative and regulatory changes. Legal, actuarial, accounting, and other fees associated with these changes are prohibitively high for many employers.

Given these realities, it is not surprising that the PBGC reports that since 1985 the number of defined benefit plans it insures has dropped from 114,000 to 44,000 and that, according to the Department of Labor, the percentage of active American workers covered by defined benefit plans has fallen from 38 percent in 1980 to 23 percent in 1995. Cash balance and other hybrid defined benefit plans have been the one hopeful sign amid this ominous trend toward plan termination. These hybrid defined benefit plans preserve the design and policy advantages of traditional defined benefit plans while responding to current marketplace demands for features traditionally associated with 401(k) and other defined contribution plans. We believe that cash balance and other hybrid plans should be viewed as a critically important mechanism for keeping defined benefit plans relevant and vital in today's changing economy.

Why Cash Balance Plans and Other Hybrid Plans Have Been Attractive

In the recent public debate, the discussion about why companies have converted to cash balance and other hybrid plans has focused almost exclusively on cost considerations. Yet we have found that, among our APPWP member companies, cost is only one of many factors considered as part of the decision to redesign a pension plan -- sometimes it is an important motive in the change and sometimes it is not. As the Watson Wyatt analysis discussed earlier in today's hearing reveals, in many instances cost has not been a primary factor in the decision to convert[1] and in many cases costs have not, in fact, decreased.[2] For many companies, conversions have been part of an overall redesign of benefits and compensation programs that has not resulted in reduced expenses.[3] For example, conversion of the underlying pension

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[1] Of 79 employers surveyed as to their motives for converting, only 39% indicated that reducing plan costs was an important or very important consideration. The desire for more stable costs (57%) and the desire to better manage retirement expense (59%) were somewhat more important factors. Of the 17 possible employer motives explored in the survey, the cost reduction motive ranked 15th, the more stable costs motive ranked 11th and the managing retirement expense motive ranked 10th. The top three factors motivating the conversion were improving employee appreciation of the plan (cited by 96% of employers), facilitating communication about the plan (93%) and an ability to show benefits as lump sum values (93%). Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

[2] In the 78 conversions analyzed by Watson Wyatt, 45% of employers realized some cost savings while 37% saw costs increase and 18% experienced a minimal effect on costs. Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

[3] In a recent survey conducted by PricewaterhouseCoopers of companies that had converted to cash balance plans, 67% of respondents indicated that the overall costs of the new retirement program (including any changes to the 401(k) and similar plans) were expected to be the same or greater over the long-term than the program being modified. The percentage is modestly higher -- 70% -- when considering short-term costs. PricewaterhouseCoopers, Cash Balance Notes, May 2000.

plan is often accompanied by institution of a stock option plan, payment of higher cash compensation or an increase in the level of company match to a 401(k) plan. In many instances, this reallocation of benefit dollars is driven by the fact that these other forms of compensation are often valued more highly by employees than the underlying pension benefit.

Other factors motivating employers to move to hybrid designs include the desire to provide the portability, individual accounts and even accrual pattern that the majority of workers are telling companies they want. Plan sponsors have concluded that, in many cases, hybrid plans better meet the needs of their particular company's workforce. The modern features of cash balance plans help companies attract and retain employees in a world where many competitor firms offer exclusively defined contribution and stock plans, which have proven to be very popular with today's workers.[4] With their account design, cash balance plans also tend to be much easier to communicate to employees than traditional plans and, as noted above, this has been an important factor for employers. This clearer picture provided by cash balance plans means employees are better equipped to monitor progress toward their retirement savings goals and to determine the level of 401(k) contributions and/or other personal savings that may be needed to supplement their underlying pension benefit.

Some critics of cash balance conversions have suggested employer motives other than those outlined above, maintaining that employers have converted their plans merely to obtain and spend the surplus assets that may exist in the company's defined benefit pension plan. Yet nothing about a conversion grants employers access to these pension surpluses for non-pension purposes. Employers face very severe excise taxes (as well as income taxes) if they attempt to withdraw pension surpluses to spend for general corporate purposes. These substantial and effective tax barriers to the use of pension surpluses remain in place before, during and after a conversion to a cash balance pension plan. The only non-pension purpose for which defined benefit surpluses may be used without penalty is to fund retiree medical expenses in certain very limited situations. Believing this to be a wise and worker-friendly use of pension surpluses, Congress late last year extended this provision of law. The bottom line is that cash balance conversions allow no new or special access by employers to pension surpluses.

These same critics also charge that companies convert to cash balance plans to cut pension costs and increase pension surpluses, thereby inappropriately boosting corporate profits. First, as discussed above, in many instances cash balance conversions do not reduce costs and so do not boost pension surplus levels. Second, and perhaps even more important, the role of pension surpluses in corporate profits is not some inappropriate effort at manipulation by employers but rather is required under the accounting guidelines of the Financial Accounting Standards Board (FASB). Under the Statement of Financial Accounting Standards No. 87, pension surpluses contribute to corporate income in the same way that pension liabilities contribute to corporate losses.

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[4] In Watson Wyatt's survey, 81% of employers cited aiding employee recruitment and 62% cited aiding employee retention as important or very important motives behind the conversion to a cash balance plan. 60% cited a desire to make the plan look more like a 401(k). Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

How Transitions Have Been Handled

Most companies spend considerable time and energy designing transition provisions to assist workers nearing retirement age who may not accrue as much in benefits going forward in the cash balance plan as they would have under the prior plan. Under current law, employees have a protected legal entitlement at the conversion to all the benefits they have already earned. Indeed, this protection of earned benefits is one of the core principles of ERISA. The transition benefits provided by the employer are in addition to these protected earned benefits. The types of transition benefits employers provide vary, but include:

- "grandfathering" some or even all employees in the prior pension plan formula;
- providing additional pay or interest credits in the cash balance plan for a period of years or until retirement;
- allowing some population of employees to choose to remain under the prior plan formula; or
- providing workers with additional amounts in their opening cash balance accounts.

As discussed above, many employers also enhance their defined contribution or other benefit and compensation plans as part of the conversion process, which can aid in the effort to assist longer-service workers.

A recent analysis of 100 cash balance conversions conducted by PricewaterhouseCoopers reveals that nearly all companies offer at least one of the transition benefits described above. Indeed, in 81% of the conversions some or all of the employees were grandfathered in the prior plan, offered choice between the prior and the new plans, or provided transition pay credits. In the remaining 19% of cases, almost all companies provided other transition assistance such as more generous opening account balances for some workers or an ongoing system of pay credits that increased by age or service.[5] Provision of these benefits belies the notion that companies engage in conversions in a cavalier manner, disregarding the concerns and interests of their longer-service employees. Rather, companies recognize the potential for lessened benefit earnings by mid- and late-career employees and provide the transition assistance described above to ameliorate these effects.

The Central and South West Experience

Mr. Chairman, let me now take a moment to describe the CSW conversion to a cash balance plan. CSW made changes to its defined benefit and defined contribution plans effective July 1, 1997. The changes included converting the traditional defined benefit plan to a cash balance pension plan and increasing the company match in the defined contribution plan. The changes made were due to employee needs expressed in surveys and focus groups as well as CSW's changing business needs. CSW received a favorable determination letter from the IRS for both the cash balance defined benefit plan and the defined contribution plan in August of 1999.

[5] PricewaterhouseCoopers, Cash Balance Notes, May 2000.

First, I would like to explain the process we used in the design of the cash balance defined benefit plan and the enhancements to the defined contribution plan. A team of employees from CSW was asked to evaluate both plans and to determine whether the plans were meeting the diverse needs of employees as well as CSW's changing business and workforce needs. The team discovered that the economic value provided by the prior traditional defined benefit plan was significantly higher than the value provided by corporate defined benefit plans generally. For example, the automatic cost of living adjustment (COLA) included in our prior plan is offered by less than 2% of Fortune 500 companies. The COLA provision resulted in a significantly higher economic value to employees than the value offered by corporate plans generally. In addition, the employee team found that the economic value of the defined contribution plan was less than the industry standard and that employees wanted more value from this plan. Instead of simply bringing the economic value of the two plans in line with industry standards, the team looked for other ways to develop value for employees. Cash balance added value by being easy to understand, by providing employees payment options that were available immediately (including a lump sum), and by expanding the benefits for beneficiaries.

Our purpose in converting to a cash balance plan and enhancing the defined contribution plan was not primarily to save money. The conversion to cash balance did create expense savings primarily through the elimination of the cost of living adjustment. We were prepared to eliminate the automatic cost of living adjustment even without the conversion to cash balance. Our cash costs for 1998, 1999, and 2000 were higher than before the changes. We anticipate that cash costs will continue to be higher in future years.

In the conversion, we wanted to minimize any detrimental impact on employees especially during the first five years. In order to do this:

- CSW used a lower than market interest rate in converting the accrued benefit – the lower interest rate created a higher opening cash balance than the lump-sum interest rate required under law;
- CSW calculated employee benefits both under the prior plan and also as if the workers had always been in the cash balance plan – over 50% of employees were provided with the higher balance that resulted from applying the cash balance formula to all years of their service;
- CSW added 13% of base pay to the accounts of all employees who were age 40 or over and had completed 5 years of service;
- CSW gave employees age 50 or over with at least 10 years of service a choice of the prior pension formula or the cash balance formula – employees make this choice when they retire;
- CSW enhanced the protected benefit earned as of the time of the conversion by adding in the full value of the automatic cost of living adjustment to the benefit earned as of July 1, 1997 (instead of having a protected annuity with an automatic cost of living adjustments each year). To include the full value of the COLA in the protected benefit, CSW assumed all employees would retire at age 55 and live to age 110, receiving the full value of the cost of living adjustment each year. This added

approximately 30% of additional value to the protected benefit in the early years of payment.

Even with these enhancements to the protected benefit, at conversion less than 2% of employees had a protected benefit that was higher than their projected cash balance benefit. The employees who could have had a potentially higher annuity benefit under the prior plan protected benefit are generally our high paid, long service employees.

As a final note, since conversion, a majority of departing employees have chosen to take a lump-sum payment of their benefit. This includes the employees who are currently grandfathered into the prior plan. In addition, with our merger close at hand, many employees will unfortunately be losing their jobs. In most instances, these employees have a better pension benefit as a result of the conversion to cash balance.

Legislative Proposals

Mr. Chairman, APPWP believes that the appropriate legislative response to the concerns that have been raised about cash balance conversions is to enhance the disclosure requirements of current law. Specifically, APPWP believes that current law can and should be improved to ensure that employees are provided with additional information about how their retirement benefits are affected by a conversion to a hybrid plan. However, we believe that moving beyond disclosure enhancements to impose new benefit mandates, as some have suggested, would be an inappropriate and counterproductive response. Such mandates would: (1) deter the use of innovative pension designs such as cash balance that better fit the American workforce, (2) hasten the decline of defined benefit pensions with their valuable retirement security features, and (3) undermine some of the basic premises of our voluntary pension system that have encouraged employers to offer pension benefits to their employees.

We at APPWP are also concerned that many of the legislative proposals regarding cash balance plans are overbroad. These bills generally fail to limit their burdensome requirements to the conversions that are the stated justification for the proposals. Instead, they impose these requirements on a broad range of defined benefit plan changes outside the conversion context. Changes such as revising the percent of pay used in a benefit formula, excluding bonuses and overtime from the definition of compensation, revising a Social Security offset, or changing how a plan credits service (e.g., from elapsed time to counting hours of service) -- all common defined benefit plan changes having nothing to do with conversion to a new hybrid design -- are changes that would trigger many of the new requirements the bills seek to impose. This overbroad response will interfere with employers' ability to manage their traditional defined benefit plans and risks accelerating the departure of employers from the defined benefit system. With the defined benefit system in decline and policymakers appropriately focused on how to revitalize it, legislation in this area should be narrowly focused to address clearly identified problems. Unfortunately, many of the cash balance proposals currently under consideration are broad in their application and reach into areas where no concerns have been raised. In the context of congressional efforts to foster simplicity in our pension laws and encourage new pension coverage and improved pension benefits, this is precisely the wrong course to take.

With these general principles as background, let me now turn to a more detailed discussion of the specific legislation that has been introduced.

Disclosure Legislation

We at APPWP believe that changes to the disclosure rules should focus on enhancing disclosure requirements when employers convert to a cash balance or other hybrid design (or make similarly fundamental changes in the plan's structure). While some modest enhancements may also be appropriate to the disclosure rules that accompany pension plan amendments generally, legislation should not impose complicated new disclosure requirements on the many common and straightforward defined benefit plan changes that can also reduce future benefit accruals for some participants.

We believe that the most effective way to provide additional information to employees about how the conversion to a cash balance plan will affect them is through an extensive set of illustrative examples that demonstrate how various representative types of workers will fare under the new plan relative to the old plan. These extensive examples would illustrate the effects of the conversion on workers of different tenure, age, and pay and would show how the two plans would compare for these categories of workers at different points in the future. These extensive illustrative examples should be accompanied by a description in words that explains the effect of the amendment on the different representative groups of workers. Such an approach – extensive illustrative examples plus prose disclosure – would be extremely helpful in informing employees about how they will fare under the conversion.

We believe that individualized benefit statements would be of only marginal additional use to employees relative to these extensive illustrative examples. Moreover, we believe that it will be extremely difficult to craft workable disclosure legislation that imposes on plan sponsors a requirement for individualized statements detailing how each employee's benefit will be affected. While we understand the desire to provide employees with personalized information of this kind, the practical difficulties associated with translating this ideal into the real world of plan operation and administration are extraordinary. The marginal additional usefulness of such statements relative to illustrative examples does not justify the tremendous additional human and financial resources that would be necessary even to attempt to comply with an individualized statement requirement.

Let me turn to a more detailed discussion of the practical difficulties associated with producing such statements. The individualized statement requirements under discussion by Congress require calculation of individual employees' accrued benefits (and, under many proposals, individualized projections and comparisons as well). An accrued benefit is the precise dollar amount of the retirement payment an individual employee has earned. Even in today's increasingly systemized and computerized world, calculation of this dollar amount for many employees, often between 15% and 20% of a workforce, requires considerable manual work. This is because computer systems do not contain many of the personal circumstances and factors – such as qualified domestic relations orders (QDROs), offsets from another retirement plan, prior leaves of absence, grandfathered benefits from an acquired company,

periods of service abroad, to name but a few -- that apply to a substantial number of a company's workers and that have an important effect on the amount of those individuals' accrued benefit. Production of potentially tens of thousands of accrued benefit statements in a period of weeks or months following the conversion (to say nothing of projections and comparisons), as many of the legislative proposals would require, simply will not be possible absent the dedication of truly extraordinary amounts of additional human and financial resources by employers.[6]

Mr. Chairman, as you are aware, the tax legislation passed by Congress last summer and the pending minimum wage legislation already approved by the Senate contain a provision to expand disclosure requirements when defined benefit plan amendments reduce future benefit accruals. This provision would require employers to provide a description of the effect of the plan change on representative classes of employees prior to the amendment and, for fundamental changes such as conversions, would require employers to provide some individual information after the amendment becomes effective. Importantly, this provision draws a critical distinction between conversions and equivalently fundamental plan design changes (which would trigger more extensive notice requirements) and simpler and more transparent defined benefit plan changes (which would be subject instead to a more modest requirement to describe how the amendment would affect employees). While imposing less severe timelines for individual information than other proposals, the provision does impose a requirement for individualized accrued benefit statements, which for the reasons discussed above we believe will be extremely difficult to satisfy. However, we believe the structure and approach of this disclosure provision is quite reasonable and we look forward to continuing to work through these issues with you and other interested Senators.

Another leading disclosure proposal is the bill introduced by Senators Daniel Patrick Moynihan and Jim Jeffords in October 1999 (S. 1708), which was prepared in close cooperation with the Clinton Administration. We believe that this bill reflects much careful and thoughtful consideration of disclosure and administrative issues and makes a number of important improvements to the prior disclosure legislation offered by Senator Moynihan (S. 659). However, we believe that a number of additional issues need to be resolved if the disclosure regime contained in S. 1708 is to be made workable. First, the bill's extensive disclosure requirements apply to all defined benefit plan amendments reducing benefits, subject to the Treasury Secretary's authority to set simplified requirements for certain amendments. We believe it is critical that this be reversed. The extensive requirements should apply only to conversions to hybrid plans and, to the extent provided by the Secretary, other fundamental design changes. Second, the bill authorizes individuals to request personalized accrued benefit statements as well as projections and comparisons under the old and new plan formulas. As discussed above, such a requirement will be nearly impossible to satisfy. Third, much of the information required to be disclosed by the bill will need to be based on certain assumptions regarding the future. If such assumptions are reasonable and clearly disclosed, employers and plans should be expressly protected from any liability based on the fact that such assumptions (and the projections premised on such assumptions) differed from actual outcomes. Fourth, the bill requires the provision, on request, of "non-personal"

[6] Even with such investment, the potential for inaccuracies under these circumstances would be substantial, thereby undermining the very purpose of the individualized statements.

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information sufficient to enable individuals to prepare their own benefit estimates and projections. This is a vague and unadministrable requirement. The bill should instead require the provision of all factors other than plan offsets (such as benefit formulas and actuarial factors) contained in the plan document that are used to determine projected benefits.

This discussion makes clear that enhancing disclosure for employees whose pension is converted to a cash balance plan raises a number of extremely challenging technical and administrative issues. With that being said, we remain committed, Mr. Chairman, to working with you and other Senators to develop and enact practical disclosure legislation that will provide employees with the information they need to understand these important changes to their pension plans.

Benefit Accrual Legislation

One of the other cash balance issues that has received attention and spawned legislation is so-called "wear-away," which is the benefit plateau effect that can sometimes accompany cash balance conversions. When employers change to a cash balance plan, they typically provide an opening balance in the cash balance account. The benefit plateau results if the value of the employee's cash balance account is less than the value of the benefit he accrued under the prior plan as of the time of the conversion. Until the value of the cash balance account catches up to the value of the previously accrued benefit, it is the higher accrued benefit to which the worker is entitled -- hence the term "plateau." While this benefit plateau results from valid and appropriate actions taken by the employer in connection with interest rate anomalies and early retirement subsidies (discussed in detail below), it can nonetheless be confusing and even upsetting to employees. We believe the appropriate way to remedy this confusion and concern is through enhanced disclosure. For the reasons outlined below, we believe the legislation that has been introduced to prohibit such benefit plateaus would unwisely limit plan design flexibility, would lead to benefit reductions for workers in some situations, and would create additional incentives for employers to depart the defined benefit system.

Before turning to our comments on the legislation that would ban these plateaus, let me briefly discuss what causes them.

- The first cause of the benefit plateaus is simply the effect of interest rates changing in the economy as a whole. The lump sum value of the benefit earned prior to the conversion will increase as interest rates fall. (This is because it will take a larger pool of money to grow to an equivalent benefit at age 65 if that pool will be earning less in interest.) The result can be that although a worker's previously earned benefit and opening cash balance account were both equal to $50,000 at the time of conversion, a decrease in interest rates can increase the value of the previously earned benefit to $55,000. Until the cash balance account reaches $55,000, this worker will experience a benefit plateau.

- The second cause of benefit plateaus is employers setting the value of the opening cash balance account by using an interest rate higher than the U.S. Treasury Department's "lump sum" interest rate to discount the value of the already earned age 65 benefit. When

this is done, the value of the opening cash balance account will be lower than the lump sum value of the previously earned benefit, meaning that workers will plateau at the higher level until the cash balance account catches up. Employers generally use a higher interest rate when they believe that the Treasury rate is historically low and the actual interest credits made to employees' accounts will be substantially higher. This use of higher interest rates has received substantial attention and criticism in the media. Yet the clear trend in recent years has been for employers to determine opening account balances using the Treasury rate or a rate more favorable for employees.[7] Thus, while employers using higher interest rates -- which has resulted in lower opening balances -- has received substantial attention, this phenomenon is not widespread today and so is not a frequent cause of benefit plateaus.

- The third cause of benefit plateaus is the elimination of early retirement subsidies from the pension plan going forward.[8] A plateau can result because workers who have already earned a portion of an early retirement subsidy prior to a conversion will typically have a previously earned benefit under the old plan that is higher than the opening cash balance account (which is typically based on the normal retirement age benefit and does not include the value of early retirement subsidies).[9] Elimination of the early retirement subsidies going forward appears today to be the prime cause of benefit plateaus in most conversion cases where plateaus are seen. While some may be concerned about this phenomenon, Mr. Chairman, we feel strongly that employers must maintain their flexibility to eliminate these early retirement subsidies on a going forward basis. Given the acute labor shortage that we are experiencing today, it makes absolutely no sense for companies to continue to offer highly-productive employees rich financial incentives to retire in their 50s. While current law protects any subsidy that employees have already earned, it wisely allows employers to remove such incentives from their plan going forward. Any change in this policy would substantially worsen the already difficult task American companies face in retaining the workforce necessary to remain fully productive and competitive.[10]

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[7] In its recent cash balance study, Watson Wyatt reports that of the 24 plans it reviewed that have converted to a hybrid design since 1994, 22 of them (92%) have set opening account balances using the Treasury rate or a rate more beneficial to employees. Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

[8] An early retirement subsidy provides an enhanced benefit if the employee leaves the company at a specified time prior to normal retirement age. For example, a fully subsidized early retirement benefit might provide an employee the same pension at age 55, say, $1,500 per month, that he would not normally receive until age 65. The ability to earn the higher pension without any actuarial discount for the additional 10 years provides a strong financial incentive to retire at the earlier age.

[9] Opening account balances do not typically include the value of early retirement subsidies because doing so would provide the value of the subsidy to a large number of workers who will work until normal retirement age and therefore not be entitled to the subsidized early retirement benefits.

[10] Moreover, any legislative requirement that employers maintain early retirement subsidies in private-sector pension plans would be out of step with congressional actions regarding our nation's public pension system, Social Security. With respect to Social Security, Congress has raised the retirement age and repealed the earnings test in order to encourage older Americans to work longer. Requiring employers to continue to offer rich private pension plan incentives to retire early would be flatly inconsistent with these actions.

The leading legislation to prohibit the benefit plateau effect is Senator Tom Harkin's S.1600, previously introduced as S. 1300. This legislation would ban benefit plateaus by mandating that benefits earned after a plan amendment be added to benefits earned under the pre-amendment formula. This same plateau prohibition is also contained in Senator Wellstone's S. 1640 discussed below. Despite the stated intent to address cash balance conversions, this benefit plateau prohibition is drafted more broadly and would reach a wide range of defined benefit changes outside the conversion context.

At the outset it should be noted that the use of benefit plateaus as a method of transitioning between benefit formulas has been expressly approved under the law for many years. Indeed, plateau periods can result from constructive and necessary plan changes, such as updating plan mortality assumptions to provide more accurate benefits, aligning the benefits of employees from different companies in the wake of business acquisitions and mergers, or revising a plan to meet new statutory requirements (such as legislative restrictions on the amount of benefits that may be paid under a plan). The ability of employers to make these necessary or desirable changes would be impaired by S. 1600.

Moreover, in the context of both traditional defined benefit plans and hybrid plans, substantial additional complexity would result from a prohibition on benefit plateaus. Such a prohibition and the corresponding requirement to separately track pre- and post-amendment benefits would require employers to maintain an extraordinary amount of outdated data in order to calculate benefits under both the prior and amended formulas. The extraordinary nature of the burden associated with a ban on plateaus is best understood in the context of almost any large company that is buying and selling businesses on a consistent basis. If the benefit formula and underlying data for every acquired business's plan must be preserved until the last "acquired" employee retires, that could mean retaining perhaps 30 or 40 different formulas with different underlying data for a period of 45 or more years.

In cases where an employer is acquiring part of another business, the burden that a plateau prohibition would impose could prompt the acquiring company to understandably decline to accept assets from the acquired business's plan. Accordingly, the former employees of the acquired company would start out as new participants in the acquiring company's plan, rather than receiving credit for past service under the former plan. The lack of past service credit in the acquiring company's plan can, in turn, have a very detrimental effect on the benefits ultimately received by these employees. Without past service credit, their benefits attributable to service with the acquired company will be provided by the former plan and will be based only on compensation earned with the acquired company. If past service credit is provided, however, their benefits attributable to the same service would be based on their final compensation with the acquiring company, which can be far greater. Thus, the plateau ban and the resulting decision of the acquiring company to decline to accept the former plan's assets leads directly to what can be a dramatic decrease in benefits for employees.

Finally, the plateau prohibition creates an extremely rigid set of requirements that would make it much more difficult to communicate and explain benefits to employees following a conversion from a traditional defined benefit plan to a cash balance plan. Rather than being able to express an employee's entire benefit as a balance in the cash balance account, an

employer would have to describe two benefit components, one from the old plan -- typically an annuity -- and one from the new -- typically a lump sum value. Such difficulties and complexities are precisely what cash balance plans were designed to remedy; they are not what an overly complex defined benefit system needs.

The debate over cash balance conversions has also generated benefit mandate legislation even more aggressive than S. 1600. Senator Paul Wellstone has introduced legislation (S. 1640) that would require employers changing from a traditional defined benefit plan to a cash balance defined benefit plan to offer all employees the option to remain in the prior plan. Moreover, employers not converting to a cash balance plan but making other defined benefit plan amendments that could reduce future benefit accruals would be required to offer vested employees the choice to remain in the prior plan or face an excise tax equal to 50% of the defined benefit plan's surplus. We at APPWP oppose such legislation in the strongest manner and believe it would lead to the unraveling of our employer-sponsored retirement system.

Under the measure, employees would have the right to reject the effect of any plan amendment that reduces future benefit accruals and the employee could instead remain under the prior plan formula. By restricting employers' ability to alter <u>future</u> benefit levels, the choice of plan mandate would mark a fundamental departure from our voluntary employer-sponsored pension system. Employers would find it virtually impossible to reduce future benefit levels in their defined benefit plans since workers could simply reject the plan amendments that carry out such reductions. Yet business circumstances (such as increased international competition, the presence of competitor firms with no pension expense, possible company bankruptcy, the need to attract new workers through alternative designs, or a general employee desire to reallocate benefit dollars to other programs – e.g., health benefits, a 401(k) plan or stock options) sometimes necessitate adjustments to pension plans. These retirement plan changes are certainly preferable to the possible alternative of outright termination of the plan, or, worse yet, the loss of jobs.

The consequence for an employer of initiating, continuing or improving a pension plan under a choice of plan mandate would be an ongoing financial commitment that generally could not be adjusted, irrespective of future competitive or business pressures. Prudent businesspeople, unable to predict either the financial future or the future preference of some employees to have their benefit dollars allocated differently, simply will not lock themselves into these unalterable benefits commitments. As a result, new pension coverage would be stalled, pension benefits would not be improved, and many employers would be prompted to terminate their existing defined benefit pension plans. These unfortunate results run directly counter to ongoing bipartisan efforts in Congress to broaden pension coverage to more working Americans and to improve existing pension benefits.

Age Discrimination

Mr. Chairman, before concluding, let me offer a few brief comments on the charge by some cash balance critics that the cash balance design and conversions to cash balance plans violate the pension age discrimination rules contained in parallel provisions of the Internal Revenue Code, the Employee Retirement Income Security Act and the Age Discrimination in Employment Act (ADEA). APPWP has responded to these charges in great detail in our recent comment letter to the Internal Revenue Service, which we have shared with your staff and which I ask be included in the record. So I will touch on only a few key points today.

We at APPWP believe the claim that the cash balance design itself is inherently age discriminatory is flawed as a conceptual matter and incorrect as a matter of law. At the conceptual level, the claim produces a distinction without substance between defined contribution plans such as 401(k)s and cash balance plans. In the critics' view, a defined contribution plan that has the same contribution rate for all workers would not discriminate on the basis of age while a cash balance plan with the same contribution rate for all workers would. Conceptually and from a policy perspective, this distinction cannot be justified.

Turning to the legal authorities, the statutory age prohibitions dictate that the "rate of an employee's benefit accrual" may not be reduced because of age. Under clear principles of statutory construction, this "rate of an employee's benefit accrual" refers to the rate of accrual spelled out in the plan document, which in the case of a cash balance plan is the rate of contributions made to the employee's cash balance account. Because these cash balance contributions do not decrease with age (and, in fact, sometimes increase with age), there is no violation of the pension age discrimination rules. Some have argued that the age prohibitions should be read differently to apply not to the rate of accrual spelled out in the plan document but rather to the annual benefit payable at normal retirement age. Such an argument is flatly inconsistent with the statutory structure. Moreover, such a reading would render substantially all contributory defined benefit plans age discriminatory and would require *increased* rates of accrual after normal retirement age in traditional defined benefit plans. Congress clearly did not intend these results.

Beyond the claim regarding the cash balance design itself, some have also charged that the benefit plateau effect that can sometimes accompany cash balance conversions violates the pension age discrimination rules. These critics charge that older employees typically have the longest benefit plateau periods. The answer to this contention is that the length of the plateau period is predominantly a function of an employee's length of service and pay history rather than an employee's age. It is certainly true that long-service workers tend to be older, which explains why older employees generally have the longest plateau periods. However, it is clear under the age discrimination law that a benefit plateau based on one or more factors -- such as length of service -- that generally correlate with age does not constitute age discrimination.

Some have also suggested that not reflecting the value of an early retirement subsidy in an opening account balance (and thereby producing a longer benefit plateau period for the workers whose previously earned benefit as of the conversion contains a subsidy) violates the age prohibitions because age is generally one of the criteria for the subsidy (e.g., attainment of

age 55 and 10 years of service). Yet the age rules of the Internal Revenue Code, ERISA and the ADEA explicitly state that the effect of early retirement subsidies is disregarded in applying the age discrimination prohibitions.[11]

Because these age discrimination arguments fail, we certainly urge Congress to resist any legislation that would treat cash balance plans or conversions as age discriminatory.

Conclusion

As this Committee continues its deliberations on the issues surrounding cash balance and other hybrid plans, APPWP recommends carefully crafted disclosure reform, not overbroad benefit mandates, as the appropriate policy response to cash balance conversions. While we support enhanced disclosure and commit to work with you toward this goal, we believe that benefit mandates will drive employers to forego cash balance plans and will risk the termination of defined benefit plans of all varieties. Such results would run directly counter to the concerted work of many in Congress, including many members of this Committee, to expand the number of Americans with pension coverage.

Thank you again, Mr. Chairman, for the opportunity to appear today. I would be pleased to answer any questions you may have.

[11] Internal Revenue Code section 411(b)(1)(H)(iv); ERISA section 204(b)(1)(H)(v); ADEA section 4(i)(6). Conceptually, the longer plateau periods for employees who have qualified for an early retirement subsidy is similar to the effect of an early retirement subsidy under a traditional defined benefit plan. The value of an early retirement subsidy decreases in the years following the year in which an employee first qualifies for the subsidy. Accordingly, under a traditional plan, an employee's net additional accruals in the years immediately after he or she qualifies for the subsidy are effectively lower than they were before he or she qualified for the subsidy. The parallel statutory provisions cited above provide that this effect, which is attributable to the subsidy, is disregarded for age discrimination purposes. Similarly, the longer plateau period, which is also attributable to the subsidy, is likewise disregarded. Any effort to outlaw the plateau period attributable to the effect of the subsidy in the conversion context would seem to unwisely endanger the use of early retirement subsidies in *traditional* defined benefit plans.

The CHAIRMAN. Thank you, Ms. Sweatt.
Now we go to Dr. Schieber.

STATEMENT OF SYLVESTER J. SCHIEBER, DIRECTOR OF THE RESEARCH AND INFORMATION CENTER, WATSON WYATT WORLDWIDE, BETHESDA, MD; ACCOMPANIED BY ERIC LOFGREN, CHAIRMAN, WATSON WYATT WORLDWIDE'S RETIREMENT CONSULTING PRACTICE

Mr. SCHIEBER. Mr. Chairman, thank you for the opportunity to testify today on hybrid pensions. With me is Eric Lofgren, the Chairman of Watson Wyatt Worldwide's retirement consulting practice. In my remarks, I will focus on our research into the hybrid plan phenomenon. Mr. Lofgren can help answer questions about our consulting with plan sponsors in regard to both cash balance and pension equity plans.

In addition to my testimony today, I refer you to two recent comprehensive research reports on private plans that we have prepared. Our analysis is based on a set of real plan conversions and a broad cross-section of real workers. Copies of both studies have been provided to the committee and the staff, and I might point out here in brief that in our research we do document that some employers in the shift to hybrid plans did reduce costs. That is part of the story, but it is a very small part of the story. Most plans indeed did not reduce costs.

The shift away from defined benefit plans that you mentioned in your opening remarks has occurred for three major reasons.

First, workers today place less value on a guaranteed future benefit than an immediate contribution of equal value put into an account in their name.

Second, regulation of defined benefit plans has been much more onerous than that of defined contribution plans.

Third, Government regulations limiting pension funding have led to the creation of deferred liabilities that many employers naturally want to avoid.

The decline in defined benefit plans has been coupled with a move toward defined contribution plans. Some view this as a problem. The Pension Rights Center, as you heard today, pejoratively calls 401(k) plans do-it-yourself pensions, accessible only to the well-off. Others are concerned about worker-directed investment in these plans; yet others worry about the financial market risk imposed upon individuals by them. Finally, some are concerned about the lack of annuities in these plans and worry that participants may outlive their retirement savings.

Hybrid plans are a response to these various pressures and concerns. Hybrid plans are more highly valued by workers who prefer an accumulating account over a promise of a future stream of income. They allow closer alignment of the accrual and funding of pension obligations than traditional plans. Compared to 401(k) plans, hybrid plans encompass all workers covered under the plan, not just those who can afford to join. Most hybrid plans leave the control of retirement assets and the financial market risk in the hands of the plan sponsor. Hybrid plans make benefits more portable than traditional pensions. Finally, hybrid plans offer an annu-

ity benefit, although I note that most participants do not accept that offer.

This litany of seemingly positive characteristics begs the question of why the reaction to hybrid plans has seemed so negative. Partly it is the result of bad press. It also reflects broad disappointment over basic changes facing the retirement system generally in our country. Partly it arises because the transition to a hybrid plan requires temporary procedures that are judged against the old plan seen in its most favorable light. It also reflects the natural difficulty we all have in accepting change, sometimes even beneficial change.

Some of the negative reaction toward hybrid plans may be well founded, but generally it fails to consider pension changes in the larger context of social, regulatory, and economic developments that we face.

The shift to hybrid plans generally is not about reducing plan cost. Most employers shifting to hybrid plans have not realized any savings in doing so. Many have actually increased their pension costs. The presentation by the prior panel, the suggestion that these plans can be fully funded on the basis of projected benefits is wrong because of limits in the tax laws. I would be happy to address that later, but it is simply wrong.

Hybrid plans have been around for nearly 15 years now. In the abstract, they are neither any better or worse than any other type of employer-sponsored retirement plan that is widely available. Because these plans distribute benefits somewhat differently than traditional pensions, some find them objectionable. In fact, the distribution of benefits in hybrid plans tends to be more equitable than it is in traditional plans.

To the extent that there have been cost reductions in the shift to hybrid plans, they have been largely related to the elimination of early retirement subsidies. The elimination of these subsidies is partially a response to the changing demographics and partially a response to Government policy.

Tight labor markets that we face today pose a situation where employers cannot continue to subsidize workers retiring in their mid–50's while they are still highly productive. In addition, employers' shift to hybrid plans is consistent with the increase in Social Security's normal retirement age that is now being implemented. Both mean reduced benefits for early retirees. Elimination of the earnings test for those who work after age 65 under Social Security and the improved deferred retirement credit reward workers who extend their careers. This is consistent with the benefit structure in virtually all hybrid plans.

One of the most controversial issues in the shift to hybrid plans is the issue of wearaway. If an employer offers an early retirement subsidy that gradually diminishes and totally disappears by the time a worker is age 55, in economic terms that plan has a wearaway feature embedded within it. I am bothered that we call the same characteristic in a transitional arrangement "wearaway" but do not call it that in a traditional plan. Economically, there is no difference in the two.

I have heard that some policymakers are interested in completely eliminating wearaway, including the wearaway of early retirement

subsidies. If that means eliminating the wearaway of the typical early retirement subsidies in most traditional plans now in operation, such a provision would double or triple the pension costs for some employers. Adopting such a provision at this juncture would simply accelerate the termination of remaining defined benefit plans.

We must consider the hybrid pension phenomenon within the larger context of retirement policy, demographic trends, and business conditions that constitute today's pension environment. We believe that there are proposed pension reform measures now before Congress to address selected problems reported about hybrid plans that has the potential to further damage the pension system that, as you noted, is already in long decline. If policymakers wish to develop new policies related to the employer-sponsored system, we urge that they proceed on a steady, deliberative basis rather than a piecemeal response to plan changes adopted by a particular group of plans.

There were about 45,000 plans, I believe, reduced in just the very limited number of States that you discussed in your opening remarks Mr. Chairman. There are only about 450 hybrid plans in operation today in all of the United States. There is something very serious going on with the system, and we ought to look at what it is before we start adopting major changes. And in that regard, I applaud the committee for holding this hearing and the deliberations that it is carrying on.

Thank you very much.

[The prepared statement of Mr. Schieber follows:]

The Shift to Hybrid Pensions Plans and the Implications: The Unfolding of a Predictable Surprise

Testimony by

Sylvester J. Schieber
Vice President
Watson Wyatt Worldwide

Before the

Senate Special Committee on Aging
Washington, DC

June 5, 2000

The views presented here are those of the author and do not necessarily represent those of Watson Wyatt Worldwide or any of its other associates.

Mr. Chairman, I want to thank you for the opportunity to testify here today before the Senate Aging Committee on the issues related to employers shifting from traditional defined benefit plans to hybrid plans. Accompanying me today is Eric Lofgren, the chairman of Watson Wyatt Worldwide's retirement consulting practice. In my statement here today, I will be primarily focusing on the considerable research we have done into the hybrid plan phenomenon. Mr. Lofgren is here to answer any questions that might arise about our consulting with plan sponsors on the consideration or adoption of cash balance or pension equity plans. There has been considerable publicity about these plans and statements made by some affected participants, some regulators, and some policymakers have spoken about Watson Wyatt's role in the evolution of the hybrid plans phenomenon. Certain activities and positions have been attributed to us that are simply wrong.

In addition to my testimony today I would refer the Committee members to two recent research reports that we have prepared on the matter under consideration today. The first is titled *The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans* published by Watson Wyatt earlier this year. The second is a paper titled "Taking the Subsidy Out of Early Retirement: The Story behind the Conversion to Hybrid Pensions," that I have written with Professor Robert Clark of North Carolina State University for a Pension Research Council Symposium held in early May this year. We believe these two research reports provide more substantial background on the implications of the shift to hybrid pension plans than work done elsewhere. The detailed results of these two studies support my remarks presented here. Copies of both of these papers

have been provided for the Committee Members and the staff. If there are any comments or questions regarding either of these studies beyond what is covered in my statement here, I would be glad to address them.

In general terms we have found that the shift to hybrid plans is not about reducing retirement plan costs. Most employers shifting to hybrid plans have not realized any savings or have actually increased their pension costs as they have shifted to this new type of plan. To the extent that there have been reductions in costs, they have been largely associated with the elimination of early retirement subsidies. We believe that the elimination of early retirement subsidies is partially a response to employers' realization that tightening labor markets and changing demographics mean workers should not be encouraged to retire in their mid-50s while they are still highly productive. The elimination of early retirement subsidies is also partially an effort by employers to align their own retirement plans with the evolution of national retirement policy.

Our analysis is based on real plans that have been converted to hybrid plans and a broad cross section of real workers. We have documented that the conversion to hybrid plans will be a very positive benefit to many workers. We have also documented that some workers will lose retirement benefits in the shift to hybrid plans. We believe that a major reason that many workers come out better off under hybrid plans and some come out worse off is that employers shifting to these new types of plans are attempting to distribute retirement benefits more equitably than they have in the past.

We have developed these analyses so policymakers can consider the hybrid pension phenomenon within the larger context of retirement policy, demographic trends, and business conditions that constitute today's pension environment. We believe that there is the potential that pension legislation intended to address selected problems that have been reported about hybrid plans could have the potential to further damage a pension system that has been in decline for more than 15 years. If policymakers wish to develop new policies related to the employer-sponsored retirement system, we suggest that they proceed on a studied, deliberative basis rather than as a piecemeal response to plan changes adopted by a particular group of employers. In that regard, we applaud this Committee for holding this hearing today.

Background

Hybrid plans have been around for nearly 15 years now. While they have received considerable negative publicity, in the abstract they are neither any better or worse than any other type of employer-sponsored retirement plan that is widely available in this country. But we all know that these plans are not offered in the abstract. They are offered in very specific situations by real employers to real workers. Because these plans distribute benefits somewhat differently than traditional defined benefit plans, some people find them objectionable.

Before turning specifically to a discussion about our research into the hybrid pension phenomenon, I would like to make a point that offering a retirement plan in this country is still a voluntary activity on the part of employers. When the Employee Retirement Income Security Act was first being implemented in the mid-1970s, there were approximately 122,000 private defined benefit plans in operation in the United States. By 1983, this number had grown to

175,000 plans. Since that time the number of these plans has steadily declined. By 1996, fewer than 64,000 of these plans were still in operation. If sponsors have continued to drop their defined benefit plans at the rate they did in the five years leading up to 1996, by the end of this year there will be fewer than 44,000 of these plans in operation. This is about one-quarter of the number of plans operating at the high-water mark.

I believe the shift away from defined benefit plans has occurred for three major reasons. First, over the past 25 years, workers have placed far less value on a guaranteed benefit that will be provided some time in the distant future than they put in an immediate contribution put into an account in their name even though the benefits may be of equivalent value. This phenomenon has been exacerbated by the relative youth of our labor markets over the past 25 years and by the outstanding performance of our financial markets. Second, the regulation of defined benefit plans has been much more onerous than that of defined contribution plans and plan sponsors have naturally migrated toward the path of least resistance. Third, government regulations limiting pension funding have led to the creation of deferred liabilities that many business managers naturally attempt to avoid. The deferred liabilities in traditional defined benefit plans, and the financial disclosure requirements that explicitly expose them, encourage employers to structure defined benefit promises in a fashion that minimizes them.

The move away from defined benefit plans has been coupled with a move toward defined contribution plans in this country. Some people view that as a bad outcome. The Pension Rights Center pejoratively calls 401(k) plans "do it yourself" pensions. They suggest

such pensions are only accessible to the well-off. Other people are concerned about the tendency toward letting workers handle the investment of assets in contemporary defined contribution plans. Here the concern is that the typical worker will not invest properly, mistiming the markets or being overly conservative. If retirement assets are not properly invested, the economic horsepower of retirement savings will not be realized. Yet others worry about the financial market risks posed to individual workers in these plans. Finally, some are concerned that workers do not tend to annuitize the assets in these plans in retirement and there is worry that many will outlive their retirement resources ending up in poverty or wards of the government.

The hybrid plan phenomenon is partly a response to the various pressures on traditional defined benefit plans and concerns about the defined contribution alternatives. Hybrid plans are more highly valued by most workers who prefer a benefit stated in current account terms over one that promises a future stream of income. Hybrid plans allow plan sponsors the opportunity to more closely align the accrual and funding of pension obligations than traditional plans. In comparison to 401(k) plans that depend on voluntary participation, hybrid plans encompass all workers covered under the plan not just those who can afford to contribute their own retirement. Most hybrid plans leave the control of retirement assets and the financial market risks associated with it in the hands of the plan sponsor. Hybrid plans make benefits more portable than those provided in traditional plans. Finally, hybrid plans offer an annuity benefit, although participants seldom accept the offer.

This litany of seemingly positive characteristics gives rise to a question of why the shift to hybrid plans has received so much adverse publicity. Partly, the negative attitude toward hybrid plans is nothing more than bad press. Partly, the negative attitude toward hybrid plans reflects the larger disappointment over broader fundamental changes that our employer-based retirement system is undergoing. Partly, it results because transition from one type of plan to another requires temporary procedures that are judged against the old plan seen in its most favorable light. Partly, the negative response of some workers toward hybrid pensions results from the natural difficulty most of us have in accepting change, sometimes even beneficial change. Changes to something as important as our future retirement security exacerbate this natural tendency. Some of the negative reaction toward these plans may be well founded, but much of it fails to consider the changes in employer-sponsored plans in the larger context of social, regulatory, and economic developments.

Reported Reasons Employers Have Shifted to Hybrid Plans

One of the widely reported motivations for the shift to hybrid pension plans has been that employers have found a clever way to reduce pension costs without workers fully appreciating what is occurring until it is too late to do anything about it. Often analyses of the shift to hybrid plans focus on a small number of hypothetical workers. If the hypothetical workers chosen for such an analysis and their career patterns are not generally representative of the workforce in question, the results of such analyses can be extremely misleading. Some of these analyses, for example, will focus only on long-career workers who are assumed to work for a single employer until attaining early retirement eligibility and then retire before

reaching normal retirement age. Such workers may represent the minority of workers employed by a given employer at any point in time. They may represent only 10 to 20 percent of workers that a typical employer might hire.

In our analysis of the shift to hybrid pension plans, we were able to gather data on 78 plans that had been converted. Our analysis was based on real plan conversions. We simulated a hybrid workforce through each one of these conversions. This workforce was comprised of a random sample of 30,000 workers drawn from 15 of our larger clients. Our analysis evaluated effects of transitions to hybrid plans on real workers, workers with highly varied combinations of age and service, pay levels, and so forth. We used realistic turnover rates that were based on actual rates developed by the Society of Actuaries on a broad cross section of plans. We believe our analysis is far more representative of the reality that participants face in the transition to hybrid plans than that provided by analysis of limited numbers of hypothetical workers.

Across the range of plans that we analyzed, we estimated the projected unit credit service costs of the prior plans and the new plans. We estimated that across this set of plans, the shift to hybrid pension plans netted employers defined benefit plans cost savings that averaged 10.3 percent of their prior plans' costs. But when we took into consideration the changes that were made to defined contribution plans in conjunction with the conversion to hybrid plans, we found that employers' plan costs declined an average of only 1.4 percent. We conclude that, on average, the shift to hybrid plans has not been about cost savings.

In the cases we have been able to document, we have found that almost two-thirds of plan sponsors that have adopted these plans have realized little or no cost savings in the shift. From this we can conclude that reducing costs and adopting a hybrid plan design are two entirely separate topics. This does not mean that some employers have not realized substantial cost savings in the shift to a hybrid plan. But plan sponsors who want to reduce the costs of an existing pension plan can do so in a number of ways. They can reduce their plan costs in adopting a less generous benefit formula even if they stay with a traditional plan form. They can reduce plan costs by simply eliminating their plans. They can reduce plan costs in shifting to a pure defined contribution plan. There are many ways to achieve cost reduction if that is the goal of a plan sponsor. The cost of a plan and the form of a plan are two separate matters.

I reported earlier that in 1983 there were 175,000 private defined benefit plans in operation in the United States and that by the end of this year the number could be down to 44,000 plans. In 1983, there were about 30 million active participants in these plans. By the end of this year, assuming recent trends persist, this number will be down to about 21.5 million. The public disclosure information gathered by the government does not allow us to estimate what happened to workers who have lost pension coverage since 1983. But we can assuredly tell you that some of the people who lost pension coverage over this period worked for employers who were reducing their retirement plan costs.

Make no mistake, we do not applaud any reduction in the commitment to retirement saving by any employer or worker. We have written extensively, given innumerable press interviews, presented hundreds of speeches before employer groups, and testified before many

congressional committees on the need for our society to have more not less pension savings. That said, some employers have found themselves in situations in recent years where they have had to reduce their contributions to the retirement plans they provide their workers. Some employers have done this as part of a package that includes the shift from a traditional pension plan to a hybrid plan. But many more have reduced their cost commitment to workers' retirement by completely eliminating their defined benefit plans. This is not a hybrid plan problem.

In our analysis, we classified employers shifting to hybrid plans into three groups on the basis of the change in the cost of their retirement plans resulting from the shift. We estimated that 45 percent of plan sponsors reduced their retirement plan costs by 5 percent or more. We estimated that 18 percent of sponsors shifted plans on a cost-neutral basis, which we defined as having costs change between 5 percent above or below the cost of the old plan. We estimated that 37 percent of sponsors actually increased their retirement plan costs in the shift to their hybrid plan. This is not a unidimensional story about cost reduction.

Changing the Employer-Based Retirement System

In 1983, the year private defined benefit plan sponsorship peaked, the nation was presented with a redirection of national retirement policy. It was during that year that Congress adopted amendments to the Social Security Act that scheduled increases in Social Security's normal retirement age. From 1935 until 2000 the normal retirement age under Social Security was 65. The only prior changes to retirement eligibility ages had been to reduce the age at which benefits could be initially paid. Under the original law this was age

65. Under amendments adopted in the 1950s, this was reduced to age 62 for women. Under further amendments adopted in the early 1960s, the earliest eligibility age for men was dropped to age 62.

The reason that Congress decided in 1983 to increase the Social Security normal retirement age starting this year was the result of the changing demographic composition of the U.S. population. Congress realized that the cost of Social Security would explode early in the twenty-first century if the baby boom generation was allowed to retire under the rules of the program that had been in operation for decades.

Now with the aging of the population, federal policies influencing retirement decisions are being retooled to deal with the new realities we are facing. In the late 1980s, we saw the elimination of mandatory retirement. We have finally reached the point of initial implementation of the increases to the normal retirement age for Social Security and there is open political debate about moving further in that direction or implementing current provisions on an accelerated basis. Just this year, we have seen the elimination of the earnings test for persons older than the normal retirement age. From a societal perspective, we have switched from encouraging early retirement to encouraging extended work lives. How should employer pensions respond to this change in national retirement policy? Part of the answer to this question lays in the answer to why prior policies have changed.

In part prior retirement policies have changed because of changing perceptions about what is fair. Mandatory retirement provisions were eliminated because policymakers decided it was unfair to force productive people out of their jobs simply because of age. Social

Security's retirement age was raised because policymakers decided the cost of sustaining the original age would be unfair to future workers in the face of growing dependency levels. Future increases in Social Security dependency levels will be driven by variations in birth rates since World War II and increases in life expectancy of retirees. Employers are facing exactly the same demographic factors as the nation faces. The costs of their pension systems are equally sensitive to the growing numbers of retirees and extended retirement periods of annuitants.

Retirement policies have also changed because of the changing dynamics of the labor market. Social Security's earnings test was criticized because it discouraged people eligible for benefits from working. In the 1930s when unemployment was rampant and policymakers thought that an older worker's retirement would create a job opening for a young worker, this policy made sense. In the 1960s, when policymakers worried about getting older workers to retire to create jobs, letting workers retire at age 62 instead of 65 made sense. It was about this time, that employers started introducing early retirement subsidies into their pension plans, providing an incentive for older workers to retire so the massive number of baby boomers could find jobs and move up existing job ladders.

In an economy where labor force growth rates are the lowest they have been in a half-century and where they are expected to fall even lower in the coming decades, such policies no longer make sense. Social Security is now implementing policy changes that encourage workers to stay in the workforce longer, not retire earlier. This is just the opposite of policies pursued in the past. Employers are operating in exactly the same environment that is dictating

changes to Social Security. In an era of unprecedented tight labor markets, encouraging workers to retire more than a decade before they will be eligible for full Social Security benefits is not a desirable policy for many employers. Many policy analysts believe it is even undesirable for the nation.

Employers that have converted their traditional pensions to hybrid plans have virtually all eliminated the early retirement subsidies in their prior plans. Eliminating the early retirement subsidy from a plan creates a cost saving. But most employers converting to hybrid plans did not realize that saving for themselves. Considering the net change in plan costs in relation to the elimination of early retirement subsidies, 48.1 percent of the plan sponsors put the full value of the early retirement subsidies or more back into their combined defined benefit and defined contribution package. Another 14.3 percent modified their plans on a basis that put some of the value realized by eliminating the early retirement subsidies back into the plan. Finally 35.1 percent of plans reduced costs somewhat more than what they would have realized by simply eliminating early retirement subsidies. For these plans, however, the largest share of their cost saving was from the elimination of early retirement subsidies.

Transitions from Old Plans to New Ones

If an employer converts a traditional defined benefit plan on a cost-neutral basis or even a cost-increasing basis, it does not mean that everyone will be held harmless in the transition from the old plan to the new. Many workers who expected to derive the full benefit of the early retirement subsidies in their old plans will feel that they have been short-changed in the shift to a hybrid plan unless they are fully grandfathered. This is not a condition that is

concentrated only on older workers. Someone 25 or 30 years of age who expected to continue working under a traditional plan may end up with reduced benefits under a hybrid plan at age 55 or 60 because of the elimination of early retirement subsidies. For many workers caught in the conversions, this may seem unfair. But fairness is in the eye of the beholder.

For a 30-year old worker looking into the future, is a new plan better or worse if it would leave her better off if she quits between ages 31 and 54, worse off if she quits between 55 and 64, equivalent at age 65, and better off thereafter? If this worker is absolutely convinced that she will remain with the current employer until age 55 and then retire the answer is pretty straightforward. But what if an industrial reorganization in the overall economy, the sort that eliminated jobs in the steel and auto industries in the early 1980s, results in the elimination of a covered job at age 40 or 50? What if the job opportunities of a spouse ten years from now take the worker out of the geographic proximity where keeping this job is possible? What if personal conflicts with a supervisor or fellow worker make staying in the job impossible at age 52 or 53? What if this worker is one of those people who finds their work particularly fulfilling and comes from a line of long-lived ancestors and wants to stay in this job until age 70?

Given the probabilities of turnover under a typical retirement plan, about 80 percent of people who are newly hired at age 30 by an employer will no longer be with that employer at age 55. The probability of leaving prior to age 55 is even higher for workers hired prior to age 30 and lower for those hired after that age. These probabilities will also tend to vary somewhat from employer to employer. We believe that few people would argue that a 30-year

old worker who was hired at the point of conversion to a new retirement plan could credibly argue that he or she had some "right" to early retirement subsidies in the prior plan. For the sake of discussion, however, assume for a moment that a class of 100 workers, all age 30, were given a choice between these two types of plans but on the condition that all had to be covered under the same plan. Given typical patterns of turnover for such workers, assume that roughly 80 of these workers will have terminated employment with this employer prior to reaching age 55. Further assume that on the day they are hired, each of the workers knows whether or not he or she will stay employed with this employer until that age.

If we assume that each of the workers is given one vote on the choice of plan and that each worker votes his or her own self interest, it is clear that this class will choose the cash balance plan by a vote of 80 to 20. On the other hand, if we weight the votes of each worker according to the potential gain or loss that he or she will realize by picking one or the other plans, the outcome is not so clear. That is, if a worker will be $1,000 better off under the cash balance plan than under the traditional plan, we will give her 1,000 votes. The worker who would be better off under the traditional plan would receive a number of votes equivalent to his potential gain from that plan. If the 80 people who are going to quit prior to reaching age 55 would each gain $1,000 on average from being in the cash balance plan but the 20 who would stay until age 55 or later would be $5,000 better off, on average, under the traditional plan, then the class of workers would choose the traditional defined benefit plan. The 100,000 votes for the long stayers from the traditional plan would clearly outweigh the 80,000 votes of the early leavers under the cash balance plan.

The problem in this case is that there is no clear way to determine which way of selecting the appropriate plan is superior. The overall benefits provided to the class as a whole would be larger under the weighted voting approach but more people would be better off under the single vote per worker model. One might think that the general welfare of the whole group would be greater if more money in total was spent on the traditional defined benefit plan but that is not necessarily the case. If there is truly declining marginal utility from added income or consumption levels, as economists generally assume, those receiving the smaller amounts might value their benefits more highly in the aggregate than the smaller group would value their larger benefits in total. Any particular worker's perception about which is the superior plan, however, will depend on their perceived probability of being better off under one or the other types of plan.

The perception that anyone who ends up being worse off under a new plan than they would have been under a prior plan often fails to take into account the relative benefits being provided under the original plan. As a simple example, consider a hypothetical example of two workers who start to work under a pension plan on the same day. Assume that one of them is 22 years old and the other 35 years old and that both have the same job titles, assignments and pay levels each year they work together. Assume that both of them work for exactly 20 years and then quit their jobs with this employer. Assume that the worker who quits on the day she is 55 years of age will be eligible to receive an immediate pension with a very significant early retirement subsidy. Finally assume that the worker who quits at age 42 will not be able to receive a pension until reaching age 65, and then with no subsidy. It would

not be uncommon that the actual cost of the pension plan for the worker who quits at age 55 would provide a benefit whose value was four to six times that of the one who quits at age 42. For the sake of discussion, let's say that the worker who leaves at age 42 in this case has accumulated a benefit that is worth $70,000 and the one who leaves at age 55 has earned a benefit with the value of $350,000. The combined value of the two benefits is $420,000 with the larger benefit being five times that of the smaller.

Now assume that the employer in this case converts to a hybrid plan five years into these workers' tenure. Further, assume that the new plan bases the annual accrual under the plan on the age of the worker. Assume that the combined value of benefits at termination is equivalent to the combined value under the old plan but that the ratio of the benefits is now 1.5 to 1.0 rather than 5.0 to 1.0. In this case the worker who terminates at age 42 would have an accrued benefit worth $168,000 and the one who terminates at age 55 would have an accrued benefit worth $252,000. In this conversion, the younger of these two workers would clearly be considered a winner in the transition to the new plan and the older worker a loser. While the loser might consider the transition to the new plan unfair, disinterested third parties could easily reach a conclusion that the overall plan had been made much fairer under the new approach.

In our analysis of actual plans, we developed a detailed case study of a plan that had shifted from a traditional plan to a hybrid plan on a cost neutral basis. Relative to the prior plan, we estimated that about 80 percent of workers would be better off under the new plan than under the prior one. The remaining 20 percent of workers would be worse off. While

the very youngest and shortest tenured workers tended to be better off under the new plan, the 20 percent who we estimated would lose in this case came from almost every age and service distribution across the total workforce. But we showed that the 20 percent who would be worse off under the new plan would continue to accrue benefits at higher rates as a percent of pay under the new plan than their counterparts who would be considered winners. Part of what is going on in the conversion to hybrid plans is a leveling of benefit accruals. In the abstract, plan sponsors are making the distribution of benefits more equitable. To anyone who ends up with fewer pension dollars as a result, the pursuit of equity in this fashion may not always seem fair.

The Perceptions and Reality about Wear Away

One of the most controversial issues in the shift to hybrid plans is the issue of wear away. My personal opinion is that the mere mention of this phenomenon creates a negative reaction toward certain plan features that is totally inconsistent with the reaction to exactly the same economic feature that is widely included in traditional pension plans. If an employer offers a subsidy that has a value of one times annual pay at age 60 that gradually diminishes to the point of totally disappearing by age 65, in economic terms that plan has a wear away feature embedded within it. I am bothered that we call the same characteristic in a transitional arrangement wear away but do not call it that in a traditional plan. Economically, there is no difference in the two. I have heard the suggestion that some policymakers are interested in completely eliminating wear away, including the wear away of early retirement subsidies. If that suggestion means eliminating the wear away of the typical early retirement subsidies in

most traditional plans now in operation, such a provision would double or triple the pension costs for some employers. I believe that adopting such a provision at this juncture would simply accelerate the termination of remaining defined benefit plans.

Wear away, to the extent that it is related to the loss of early retirement subsidies earned up to the point of transition to a hybrid plan could be protected in the transition to a new plan if policymakers really wished to do so. I would suggest that if we are going to "vest" workers in early retirement subsidies that they have already earned in their traditional plans prior to conversion, that we should maintain the same wear away schedule for these subsidies that are embedded in pre-conversion plan. Vesting these benefits, however, may require that we revisit a wide range of existing provisions in pension law that are unevenly applied to the economic operations of defined benefit and defined contribution plans. Providing a pop up cash value equivalent to the earned early retirement subsidy at age 55 may be contrary to regulations limiting backloaded benefits. While the economic value of benefits in a traditional pension plan can increase significantly at early retirement age without causing backloading problems, providing an equivalent value in a cash equivalent context probably would.

Conclusions

In the final analysis, my perspective on hybrid plans is driven by the very real considerations that our economy is facing. First, labor markets are going to be tighter over the next few decades than anyone in the labor market today ever remembers. Employers are going to need to keep workers longer than they did during the past three or four decades if our economy is to continue to grow and thrive. Second, the savings rates that currently persist in

our economy will not allow the baby boom generation to retire in the same fashion that the current generation of retirees have been able to do so. Simply put, people are going to have to work longer to accumulate adequate resources to finance an extended retirement period resulting from the steady improvements in life expectancy.

It is within this context that policymakers need to assess whether the move to hybrid pension plans is desirable. To a certain extent, the answer to this question is in the eye of the beholder. We know, however, that the shift to hybrid plans is consistent with a number of other elements of national retirement policy described above, and in particular would put employer pensions more in alignment with Social Security policy. Proponents of Social Security have often suggested its superiority to employer pensions because of its greater portability. Hybrid plans provide significantly more portability than traditional defined benefit plans. Critics of hybrid plans suggest that such plans are unfair because they do not provide the accelerated growth in benefits late in workers' careers that traditional defined benefit plans provide. However, hybrid plans provide more level accruals over workers' whole careers and provide much higher accruals late in workers' careers than Social Security does. As policymakers struggle to encourage workers to extend their careers to make entitlement programs more sustainable, it is hard to conceive they would be simultaneously interested in discouraging employers from adopting pension plans that support that policy goal. We know that the elimination of subsidized early retirement in employer pensions in general would put employer pensions on the same status as Social Security. Social Security allows early retirement but requires a reduction in benefits that is approximately actuarially fair.

Given the recent change in public policy meant to encourage delayed retirements, we hope policymakers will carefully consider the hybrid pension phenomenon in a broader context than that suggested by a relatively limited number of anecdotal cases that have captured so much public attention. Congress cannot legislate pension regulations that will ameliorate the tight labor markets U.S. employers already face or the increasingly tight labor markets they are likely to face in coming decades. Adoption of new requirements to maintain early retirement subsidies that do not make sense in this environment will put the employers who have stood by their defined benefit plans at a competitive disadvantage relative to those who abandoned them years ago or never offered such plans in the first place. In addition, it will create a retirement policy schizophrenia where federal legislation is simultaneously trying to encourage workers to remain in the workforce for extended periods but forcing some employers to offer them benefits that encourage their workers early exit from the workforce.

The CHAIRMAN. Thank you, Dr. Schieber.
Now, Mr. Woyke.

STATEMENT OF JOHN F. WOYKE, OF VALHALLA, NY, PRINCIPAL, TOWERS PERRIN, REPRESENTING THE U.S. CHAMBER OF COMMERCE

Mr. WOYKE. Yes. I have submitted a prepared statement which is in the record. Rather than summarize it, I am going to show two charts. I am going to ask my associate, Katie Kalmus, to put them up, and these charts, I think, will illustrate graphically what the conversion issues are in this type of plan versus the old plan.

The first chart shows the annual increase in value of two plans. One provides 1 percent of final average pay per year of service, and the other provides 5 percent of current pay in a cash balance plan growing at 6 percent fixed interest. The numbers were chosen to produce exactly the same benefit at age 65 in terms of dollar value. Therefore, the area under each line is exactly the same.

Now, I will ask Katie to point out two gaps. If you can see, at earlier ages the cash balance plan grows faster because the value of 5 percent of pay at an earlier age is more than the 1 percent pension you are going to get at age. And then, about age 56 in this design, the traditional defined benefit catches up and starts making very large contributions in value growth so that the area under the graph will be equal when they reach 65.

Now, the transition problem is those employees who leave during the gap of the younger ages, who are already below the blue line and don't get the big gap between the blue and the green lines at the older ages. Most companies handle that by setting an age such as 50 where they grandfather employees. If they don't or if the employee is age 49, such as Mr. Bruggeman, there will be a gap in total value because the employee will not have gotten the full value of the area between the lines at the end of his career.

Now I am going to ask Katie to put up the next chart, which the identical chart, but it shows what happens to an employee wh works beyond normal retirement age. As you can see, there is plunge in the rate of value with the traditional plan. And why that? That plan is still giving an increase based on total pay, still accruing every year, but virtually all plans give what they ca a suspension of benefits notice. And all this says is, by the wa if you don't leave now, your pension starts at age 66 or 67, whe ever you actually retire. So you are working and you are gettir your pay and you are getting increases in your pension, but you a losing a year's benefit for every year you work because you cou have gotten cash money by retiring and not working.

Now, let me explain the other line, the blue line with the cas balance plan. Traditionally cash balance plans don't give a suspe sion notice and don't suspend benefits. As a result, their benefi continue to grow for the older worker. And I don't see anything di criminatory about giving an employee in his full career money an earlier age rather than all bunching it up just before retiremen And I don't see anything discriminatory about allowing somebo who chooses to work after 65—and more of us are wanting to this—to continue to earn meaningful pension benefits. And a ca balance plan does both of those.

In summary, there is nothing inherently discriminatory about cash balance plans. I am not saying they are inherently virtuous. I am not saying that the traditional plan is inherently bad. They are just different. And in our society, the traditional plan is based on the plans developed by Bismarck in Germany in the 19th century. We have now entered into the 21st century. Designs of retirement will change. People live longer. They are going into phased retirement. There are changes.

So we ask you on behalf of the U.S. Chamber of Commerce, do not attempt to use the law to stop employers and employees from designing the plans that are best for their workforces.

Thank you.

[The prepared statement of Mr. Woyke follows:]

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Statement of the U.S. Chamber of Commerce

ON:	**CASH BALANCE PLANS AND AGE DISCRIMINATION**
TO:	**SENATE SPECIAL COMMITTEE ON AGING**
BY:	**JOHN WOYKE**
DATE:	**JUNE 5, 2000**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross- section of the American business community in terms of the number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – numbers more than 10,000 members. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 83 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

ON: CASH BALANCE PLANS AND AGE DISCRIMINATION

TO: SENATE SPECIAL COMMITTEE ON AGING

BY: JOHN WOYKE

DATE: JUNE 5, 2000

Good afternoon, Mr. Chairman and members of the committee. My name is John Woyke, and I am an attorney and enrolled actuary with Towers Perrin. I am here today on behalf of the United States Chamber of Commerce, on whose Employee Benefits Committee I serve. The Chamber represents over three million businesses of every size, sector, and region of the country.

I appreciate the opportunity to comment on cash balance plans, particularly as they relate to older workers.

Perspectives on Cash Balance Plans... Do They Discriminate Against Older Workers?

In the public debate over cash balance plans, one of the loudest complaints raised by opponents of these plans is the contention that they discriminate against older workers. The employees who testified to Congress during last year's highly publicized hearings seemed to tell a convincing story when they talked of the thousands of dollars that they said they had "lost" when their employer converted from a traditional final pay plan to a cash balance plan.

It's no secret that we live in age in which corporations continually strive to operate more efficiently. So it was easy to believe that companies had found a new way to improve the bottom line by converting to a new pension plan design at the expense of older workers who typically cost the most in terms of pay and benefits.

Complex rules

But is this what's going on? We offer an emphatic no! Real life is often complicated, and that's certainly the case when it comes to understanding how pension plans work, and particularly how benefit calculations are made in plan conversion situations. Determining how much to credit to the new cash balance accounts of employees depends on key benefit policy decisions in the context of the employer's financial management strategy as well as highly technical assumptions and calculations. Moreover, there are specific laws and regulations that employers must follow to be fair to their employees, and that includes making sure that there's no discrimination against older employees in the accrual and distribution of pension benefits.

So let's take a close look at the law and the regulations designed to protect older workers against discrimination in the calculation and delivery of pension benefits—and see what employers must do when they adopt cash balance plans.

It's the law

The legal requirements protecting against discrimination based on age derive from Section 411(b)(1)(H) of the tax code, which forbids a defined benefit plan from reducing an employee's rate of benefit accrual with increasing age. The Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act of 1967 (ADEA) contain parallel provisions.

Cash balance plans, of course, express the benefit as a contribution credit to an individual's account each year, generally as a percentage of pay. Typically, these credits range from 4% to 8% of pay, and the account grows over time as the credits accumulate and generate investment earnings specified by the plan. The actual credits may vary depending on age and service, or employers may use a fixed rate for all employee accounts. Whatever the design, these plans have the look of a defined contribution (DC) plan, making them easy to understand even though technically they are defined benefit (DB) plans. They're simple to understand, and they appeal to younger employees because the retirement benefit accumulates steadily—in contrast to final pay plans that are "backloaded" to provide the greatest reward to employees with many years of service.

In fact, many cash balance plans are "front-loaded." While this has a particular technical meaning as far as the IRS is concerned, a look at Chart A is one way to show this conceptually. Here we compare a traditional defined benefit plan that provides an accrual of 1% of pay per year of service with a cash balance plan that provides a contribution credit of 5% for each year of service. The chart shows how much annuity, beginning at age 65, the value of each accrual will buy. Here we see a contribution credit in the cash balance plan "buys" progressively less in terms of an annuity, because as an employee approaches normal retirement age, each year the account balance will have less time to earn interest credits.

Opponents of cash balance plans point to this falling line to argue the plans discriminate against workers as they get older. Proponents point out, however, that the rate of benefit accrual *as defined by contribution credits* for a typical cash balance plan stays level year after year. Because the rate stays the same as an employee gets older, there is no discrimination. All employees get the same percentage of pay set aside in their accounts.

Even if cash balance plans were discriminatory (and we certainly believe they're not), what would this mean in practical terms for employers and employee savings plans? *If defined contribution plans were held to the same standard*, it would mean that virtually all 401(k) plans discriminate against older workers because their accounts are structured in the same way as cash balance plans, with a contribution based on a fixed percentage of pay. This is, of course, an absurd result, but it would be the logical extension of accepting the argument of cash balance opponents.

Intent and practice

In the preamble to the final non-discrimination regulations (Regs. 1.401(a)(4)-1 through -13), the Treasury Department and the IRS noted the way interest credits accumulate in a cash balance plan and expressly rejected the age discrimination argument. In addition, the regulations implicitly approve front-loaded cash balance plans by providing a safe harbor for plans with a uniform contribution rate—perhaps the most common type of plan design.

The discrimination argument, of course, diverts discussion from the more easily understood nature of cash balance plans, as shown in Chart B. Here, it's clear that the value of the accruals in the cash balance plan are greater for younger workers than under the traditional plan. On the other hand, the value of accruals are greater for the older workers in the traditional plan. The chart illustrates why many younger workers like cash balance plans which can provide more for workers who change jobs and take their account balances with them.

Wear-away

Another argument used by opponents of cash balance plans is based on the "wear-away" phenomenon that can occur with some employees when a company calculates

the value of the frozen accrued benefit when converting from a traditional pay plan to a cash balance plan. If the new account balance is less than the value of the accrued benefit, the employee has to work for some period to make up the difference. For technical reasons related to early retirement subsidies, and the fact that traditional plans are heavily backloaded, older and mid-career employees may be subject to more wear-away than younger workers when the employer converts to a cash balance plan. Indeed, many younger workers may not experience any wear-away at all.

For example, let's consider an older employee with an opening account balance of $190,000, whereas the lump sum value of his previous accrued benefit was $200,000. Let's also consider a younger worker with fewer years of service who has an opening account of $9,500, also equal to 95% of the lump sum value of his previous accrued benefit. Clearly, it will take a longer period for the older employee to "make up" the $10,000 "shortfall" than it will for the younger worker to make up a $500 "shortfall." Again, cash balance opponents say this is age discrimination.

That argument is too simplistic and overlooks what's really going on. The length of the wear-away period is generally not a function of an employee's age, but rather an employee's pay history and length of service. And it is clear under the law that a benefit adjustment based on one or more factors that generally correlate with age is not based on age discrimination. Moreover, an employee's age is quite distinct from years of service. So even if a wear-away period were considered a reduction in the rate of benefit accrual, there would not be a violation of section 411(b)(1)(H) because the benefit formula is based on pay history and service, not age.

Furthermore, the prior benefits may not have been available in the form of a lump sum and, therefore, may not have been portable. It is true that the actual benefit received can never be less than that which was previously accrued. *The issue here is*

about increases in accrued benefits going forward. There are no takeaways in cash balance conversions.

The big picture

We've focused on some rather narrow, technical issues to try and explain some of the points that come up when there is a discussion of age discrimination in connection with cash balance plan conversions. However, what's perhaps more important to understand in these situations is that employers typically adopt a variety of approaches to create an entirely new retirement benefit structure for employees. If they seek to replace a traditional final pay plan with a cash balance plan, in most cases they provide transition benefits for mid-career and older employees who are most affected. These can take the form of "grandfathering" current employees under the old plan, providing additional credits in their cash balance accounts, or guaranteeing a minimum benefit based on the prior formula. Moreover, in many cases an employer's shift to a cash balance plan is part of a complete overhaul in retirement strategy that may include additional awards of stock or a higher contribution to the company's 401(k) plan.

We continue to believe that it is up to employers to decide what retirement strategy works best for them within a total financial management framework. Obviously, different industries and companies will tend to take different approaches based on their business objectives, resources and overall philosophy about rewarding employees and helping them prepare for retirement. Cash balance plans are one such approach.

Flexible approaches

Even with the popularity of 401(k) and other defined contribution plans, as well as the growing use of stock to reward employees, the vast majority of Fortune 1000 companies continue to sponsor DB plans. Indeed, research indicates that employees tend to prefer DB plans over DC plans as they advance in their careers, grow older, and realize the importance of preparing for retirement. Cash balance plans have proved attractive by combining features of both approaches—with regular contributions that are appreciated by the employee and a stream of guaranteed income insulated from investment risk.

As with any pension plan, cash balance plans must be described carefully and fully to employees. In this context, employers have a responsibility that includes proper disclosure about how these plans work, especially in conversion situations. We believe employees have a right to be notified when their employer is adopting a cash balance plan, and to receive an easily understandable statement of accrued and projected benefits. But any changes to the current pension system, which is highly regulated, must be made with care. Cash balance plans should be allowed to stand on their own merits, and employers must be allowed to remain flexible and adopt creative benefit strategies for their employees in a rapidly changing, competitive marketplace.

CHART A

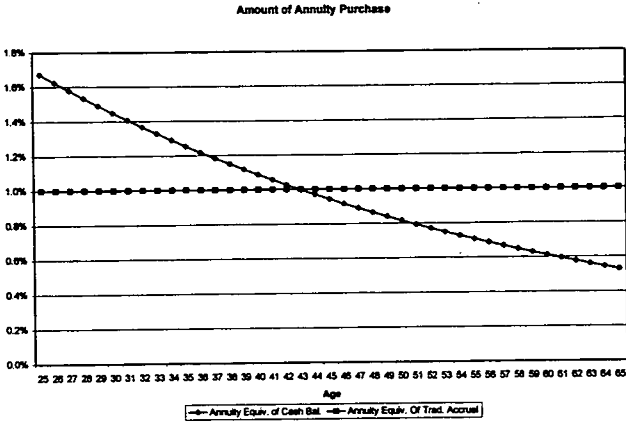
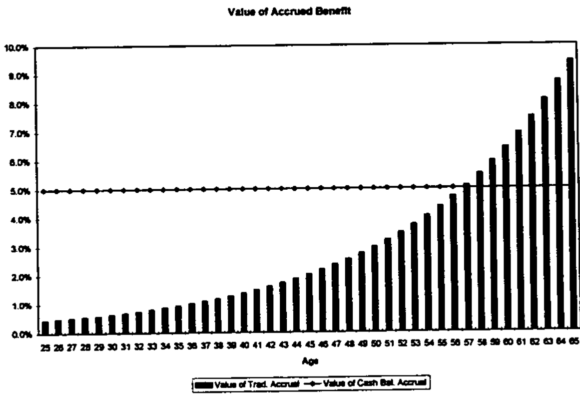


CHART B



The CHAIRMAN. Well, thank you all very much.

We have been joined by Senator Wyden of Oregon, and let me ask Senator Wyden what his druthers are. I have about a half hour of questions. I can start out and then give you some time, come back and finish up, or I would be glad to defer to you right now if you would like to have me do that.

Senator Wyden. Whatever is your pleasure, Mr. Chairman. You have been doing the heavy lifting here.

The CHAIRMAN. I think I will defer to you right now, and then I don't have to worry about whether or not I am keeping you too long.

STATEMENT OF SENATOR RON WYDEN

Senator WYDEN. I think with your leave, Mr. Chairman, perhaps I could just make a short statement and then stay for some of your questions.

First, Mr. Chairman, let me commend you for scheduling this hearing. I think this is an extremely important topic, and on this issue and so many others, your leadership has given the Aging Committee a chance to dig into these questions, and just know that it is very much appreciated.

I am hopeful that this issue of cash balance plans will help spark a discussion of how it is that the United States is the only Western industrialized nation that lacks a comprehensive retirement policy. For so many in our country, this has, in effect, led to folks in Iowa and Oregon and across the country going to work somewhere shortly after they graduate from high school and staying put until somebody gives them a gold watch many years later and thanks them for their contribution.

Now, for the short term—and I think your efforts and Senator Harkin's and others' reflect the need to initiate a set of reforms that balance the competing needs of the older worker and the younger worker. I hope, Mr. Chairman, that with your leadership, as we look at this cash balance question, we can begin to factor in all of the components it is going to take to develop a sensible national retirement policy. We did take a step forward here recently by eliminating the Social Security earnings ceiling, which is something that you and I both supported to make it more attractive for older people to keep working. We haven't begun to really look at demographic changes or the changing nature of work with so many folks making a living by pressing the "enter" button a lot of times during the course of the day rather than doing physical labor. So I am glad that you have chosen to lead the committee to examine this issue.

I am going to stay for as many of your questions as I can, and then I hope to have some of my own. I think this is a very important issue in and of itself, and, frankly, I think it is even more important when put into the broader context of what it is going to take to really develop a comprehensive national retirement policy for this country because as of now, we are the only Western industrialized nation that lacks such an approach.

I thank you and I look forward now to your questions.

The CHAIRMAN. Thank you very much, and I will be glad to defer to you anytime you make a request.

I will start with you, Ms. Sweatt. Was the decision by Central and South West made to move the cash balance plan influenced by the current deregulation of the electric utility business?

Ms. SWEATT. Sir, our decision to move to a cash balance was actually influenced by two things. One was obviously our changing business needs, and so as CSW looked at the future of the electric utility industry, we certainly knew it was going to be very different than where we had been in the past.

In addition, though, we also looked at what our employees' needs were, and those have changed significantly since when we first introduced the pension plan.

The CHAIRMAN. Did you consult with your employees when you were considering changes in your retirement plans, with just the union, or did you also consult with the non-union employees?

Ms. SWEATT. Actually, our process was in around 1994 we developed a team of employees that were non-union employees, and they looked at our total benefits package, so not even focusing on just the retirement, but actually on the complete compensation package we were providing them. Their first step was really to analyze whether the package we were providing met employees' needs and then met our business needs. After they determined that, they came back and started designing the plan in around 1996.

The CHAIRMAN. So you consulted with both union and non-union employees?

Ms. SWEATT. Primarily non-union to begin with, and then union were brought in later.

The CHAIRMAN. Was the change that you made influenced by how much the workforce valued or understood the traditional plan?

Ms. SWEATT. Absolutely. During the process—our team was called BEST, Benefit Evaluation Study Team, and during their process what they found were many of the components of our pension plan were either not valued by employees or they were unaware.

On the other side, on the defined contribution side, employees continued to stress how much they valued that plan and wished they had more flexibility.

So some key things we heard from employees were really portability, flexibility, simplicity, make it simpler, easier to understand. And so that is what that package was really designed to do.

The CHAIRMAN. What is the average tenure of employees at your company? And what I am trying to find out here is some understanding of how many of them are likely to vest in your plan.

Ms. SWEATT. Absolutely. Our average tenure is 14 years, so we are traditional utility. We have long-service employees.

The CHAIRMAN. What has been the general employee reaction at Central and South West to the change to the cash balance plan?

Ms. SWEATT. Employee reaction overall has been very positive. I am certainly not going to say it has been easy. We have gone out and done numerous focus groups after the fact and really talked to our employees to make sure they understood.

In late 1997, Central and South West announced a merger with an American electric power out of Columbus, OH. Because of that merger, we have a significant number of employees who thought they would make it to age 55, 56, 57 to retirement who now will

not. And they have a significantly higher benefit under cash balance than they would have had under the prior plan, plus they have the portability to take that somewhere else.

So we feel that employee response has been very positive, and in light of the merger, one of our key questions that we get from employees is: You are not going to take this away, are you?

The CHAIRMAN. I want to refer to some cash balance-related bills that are in Congress. Why do you regard the scope of the pending legislation as such an important issue?

Ms. SWEATT. I think that, Mr. Chairman, as you have pointed out, the pension system in itself needs to be strengthened. And so it is very important that we be very careful in how we do that.

Currently, employers are dropping out of the pension system. Cash balance gives us an opportunity to continue to provide those benefits in a much easier way. It is administratively easier. But if we provide additional burdens on top of that, it eliminates another opportunity to add employers back into the pension system.

The CHAIRMAN. Let's look at some of those details. Would you describe some of the administrative burdens associated with running a defined benefit pension plan and why you think that additional legislative requirements could lead more employers to leave the defined benefit system?

Ms. SWEATT. Sir, currently right now the costs associated with a pension plan are significantly high. So when you think about the accounting that you have to do every year, the actuarial analysis that is done every year, the plan administration that is done every year, the limits on the plan, on the plan's changes, legislation changes every year, all of that, in addition to the complex formulas, requires changes to the system to really make it work for employees. So the administrative burden is significant.

In addition, the pension system has been around for so long. You have old plan provisions that you are continuing to carry forward, and those can get very complicated. So you could end up with numerous formulas out there for 40 to 50 years in the future, which is very difficult for a plan sponsor to have to continue to provide.

The CHAIRMAN. Did Central and South West provide any transition benefits at the time of conversion or as part of it? And if so, what are they?

Ms. SWEATT. We actually provided what I consider five different transition benefits. Three of them I addressed in my oral commentary.

The first was that we used a lower-than-market interest rate, so at the time interest rates were at 6.48 percent. We used 6 percent, which resulted in higher opening cash balances for our employees.

We provided a transition credit of 13 percent of base pay to employees that were age 40 or over and had 5 years of service on the date we transitioned.

We grandfathered employees that were 50 or over and had at least 10 years of service, which basically meant that they have a choice any time in the future when they retire between cash balance and between the prior pension plan.

In addition, we did two that are more complicated. One is what we call always cash balance, and so we went back and assumed we had had this new cash balance formula in place since the employee

was first hired and created a benefit under that formula. That resulted in a higher opening balance for 50 percent of our employees, so more the career average type of benefit.

The other provision really has to do with the wearaway. When we calculated the protected benefit, we had a very challenging situation in that we had a cost-of-living adjustment that was protected. Our plan had an automatic cost-of-living adjustment in it.

Really, under law, all we had to do was provide an annuity with the potential of cost-of-living adjustments in the future. But that is very complicated to explain to employees of how you compare an annuity with a COLA and a flat annuity, which is what cash balance provides.

So what we did instead is built in the full value of that up front and basically said what was the maximum somebody could get from the cost-of-living adjustment based on the actuarial regulations. That added about 30 percent into the enhanced—what we call the enhanced protected benefit. So ours is about 30 percent higher in the first several years.

The CHAIRMAN. I keep hearing about wearaway, and it seems to be the most controversial aspect of this. Explain to me why you think that wearaway can be justified, because I just don't understand it. By that I mean it seems to me that something somebody is entitled to is lost.

Ms. SWEATT. I think that there are a couple things. Wearaways have been legal for years, and so without the context of cash balance, I could make a reduction in pension and wearaway was legal. So——

The CHAIRMAN. Along that line I think I can show that the Treasury Department has tried to even encourage wearaway in some cases. So we have some place, maybe in a non-written way, an agency of the Federal Government trying to justify it. That doesn't mean I agree with it.

Ms. SWEATT. OK.

The CHAIRMAN. It probably makes you stronger in your position.

Ms. SWEATT. Well, and I think that that's just a minor point in this. I think there are a couple of others that are very significant. One is that wearaway can be created by interest rate anomalies. So when you look at our plan in a 5.25 interest rate environment, there is a much bigger wearaway issue than a 6.5 interest rate environment. And so from one year to another year my wearaway bounces around because the annuity under the cash balance is fluctuating. The lump sum under the old plan is fluctuating.

So if you look at the interest rate anomaly, that can create wearaway. I think also wearaway could—if you banned wearaway, it could create some issues when you are trying to merge a plan, because what happens is that you would have to say A plus B; well, B only might be better in certain circumstances. So you could say—so wearaway could actually cause a reduction in benefits because it could force companies to say we are not going to combine these plans.

The CHAIRMAN. Why would you oppose individualized benefit statements?

Ms. SWEATT. I support enhanced disclosure, and I think it is very important to find a way to get to a good answer on enhancing that

disclosure. And the APPWP as an association really does support providing additional information to employees.

What gets very complicated in the context of really looking at individualized is a number of different things. Again, you have an interest rate issue. So what interest rate do you pick to show the employee the wearaway or the potential benefit? Because a one percent difference can make a significant impact on that benefit value.

In addition, I think that companies are concerned about the liability, so if you provide a projection statement, it could potentially impose liability on the employer.

I think in addition the complexity of the administration is very difficult for an employer to do under the timelines and things like that.

The complexity, 15 to 20 percent of our calculations today are manual, and so if you look at doing that as a projection, that is significant. So when you have 15 to 20 percent manual today, you would have to add that on top. And those manual calculations are really from, you know, QDROs, qualified domestic relation orders, or acquiring companies that have past benefit service, old plan rules, old legislative rules. And so really when you have to do that, every time you have to do a calculation you are really doing 15 to 20 percent manually.

The CHAIRMAN. Now, you said you were for more disclosure. What would you agree to give participants so that they can understand the magnitude of the change of the plan?

Ms. SWEATT. I think in the APPWP we believe that what we need to do is create detailed, more generic type of statements that really outline all the different scenarios under the plan. So very detailed statements, but not specific to an individual per se. So more general characteristics of an employee class.

The CHAIRMAN. What is the problem with requiring employers to make the early retirement incentives a permanent feature of the plan?

Ms. SWEATT. I think really there are two considerable issues there, and these are two that Central and South West definitely had to address. The first is in recruiting and retaining employees. Our workforce is changing, and Central and South West, when we looked at this, understood that we didn't necessarily want people retiring at 55 anymore. We need that talent going forward. We need those workers. And they are an important part of our business, and they are an important part of our future.

The other side of that is that we also understood that the talent of the future, the people we want to attract, that we want to actually go out and recruit, may very well be the 49-year-old, the 50-year-old, the 55-year-old. And so we wanted something that looked very appealing to those employees or those future workforce also, and a cash balance which they are building this lump sum is more appealing than a more service-based approach.

The CHAIRMAN. Dr. Schieber, I want to be fair to you because I asked Mr. Perkins in the previous panel to comment on a couple quotes you gave. And both of these discuss cost-cutting in conversion to cash balance plans. For everybody's reminder, let me read the two statements.

"One of the motivations to move to cash balance plans is they do provide cost savings." And then the other quote is: "They said they wanted to cut costs and, by golly, they did."

Now it is your turn to comment.

Mr. SCHIEBER. In our analysis of plans, we divided plans into three groups. We characterized those who reduce pension cost by more than 5 percent as cost reducers. We characterized those whose costs changed as they went from the old plan to the new plan by plus or minus 5 percent cost-neutral shifters. And we characterized those who increased costs more than 5 percent as cost increasers.

We found in our study that about 44 or 45 percent of the plans that we could gather data on were cost reducers. About 18 percent or so were cost neutral, and the remainder were cost increasers, so something slightly over a third were cost increasers.

We also did a survey of plan sponsors who had converted in the process—had converted from a traditional plan to a hybrid plan, and we asked them for what their motivations were for changing their plans. And the different groups had different major motivations in terms of what they were trying to achieve.

One of the things that the cost reducers indicated that came out in our analysis was that one of the things they were trying to do in their conversion was reduce costs. There are many ways that plan sponsors can reduce costs if they want to change their retirement plans. I will refer back to the chart you put on the table here in your opening remarks Mr. Chairman. Many of those employer's that dropped their defined benefit plan probably did not institute any kind of replacement plan. Many of them probably instituted a stand-alone defined contribution plan that was cheaper than their old plan.

If an employer needs to reduce costs for whatever set of reasons, there are a variety of ways that they can do it. And to say that some of them were not motivated by cost considerations when they moved from their traditional plan to a hybrid plan I think would be wrong.

But in the overall analysis, the cost reduction was not what the majority of the plans were trying to achieve. My "by golly" quote was simply saying that the people who set out to reduce costs, one of the things they did in their shift was reducing their cost. It is not that this is the only reason that employers go to hybrid plans. It is one of the motivations, and some employers were pursuing that, and in the process of changing plans they did reduce costs.

The CHAIRMAN. If you think that employers are being motivated to shift to hybrid plans in order to reduce their pension costs, do you think that new mandates potentially increasing pension costs will not cause cost-conscious employers to take even more drastic actions such as freezing their plans?

Mr. SCHIEBER. Well, they will either freeze—I would guess what they would do is they would simply freeze their plans. At least up until now, these have not been mandated benefits, and as long as they are voluntary benefits, I would think that employers can exit them. And there are a variety of ways that they can do so.

The CHAIRMAN. And, Mr. Woyke, I would ask you whether you agree or not with what Dr. Schieber just said.

Mr. WOYKE. Yes, I agree. In fact, there are many companies who need to reduce costs and do it by freezing their plans.

The CHAIRMAN. What percentage of hybrid plan sponsors are currently in contribution holiday? And how does that compare with the percentage of traditional plan sponsors in a contribution holiday?

Mr. SCHIEBER. I am not sure of the exact number that are currently in contribution holidays. In our study of plans that we released earlier this year, we looked at the funding status of traditional plans and hybrid plans. The distribution was virtually identical. We looked at contributions per active employee. The distribution of contributions per active employee was virtually identical between hybrid plans and traditional plans. We looked at the assets per participant, and, again, they were virtually identical.

The funding status of traditional plans and hybrid plans to us seems to be—there is little difference.

The CHAIRMAN. Would you give Mr. Lofgren your—you will probably have to move it more in front of you. I am sorry.

Mr. WOYKE. Maybe he could use this one.

The CHAIRMAN. Yes, well, either way. In a series of articles in various national media, Watson Wyatt has been criticized for using consulting tools used to help employers cut pension costs, which then ended up hurting "older" workers. These include the aging diagnostic to show how pension costs increase as workers age and the SPOT to help employers determine when it is cheaper to pay a lump sum than an annuity.

Do you think that these kind of things may be discriminatory or at least unfair to workers who may be disadvantaged after long careers with employers that you are counseling to change plans?

Mr. Lofgren. Well, the answer, Senator, is that the tools were mischaracterized as to what they do. The article that referenced SPOT was an article looking at the difference between the lump sum available at early retirement and the value of a subsidized early retirement annuity because the lump sum need not reflect the full subsidy under current law. SPOT has nothing to do with that. What SPOT does is help employers find a dividing line for a minimum lump sum of equal value to the annuity. Under current law, employers can mandate that only a lump sum be taken if the value is under $5,000.

What we were doing with this tool was simply suggesting to employers that it might be worthwhile to have a lump sum dividing line of $7,500 or $10,000 or whatever the equivalency worked out, which means giving employees a choice in the tradeoff of administrative carrying costs for perhaps 40 years or 30 years for a 35-year-old who changes jobs, and it is younger people who change jobs more often, and that the employee typically would enjoy the choice. And the choice that was analyzed was actually an equal-value choice. So the article was basically incorrect in its presumption as to what the tool did.

The aging diagnostic tool addresses the changing workforce. Senator Wyden said that it is very important to look at demographic changes and the changing nature of work. This is a tool to help individual employers to do just that. There is an article in today's Wall Street Journal titled "IRS Faces Shortage as Some Workers

Near Retirement." It starts off saying, "More than half the IRS, its most critical employees are eligible for retirement, and few replacements are waiting in the wings. Resolving the problem could take years."

Our tool was simply a methodology to help employers realize what was coming up while there are still years to go to do some preplanning.

The CHAIRMAN. Since you head up the retirement consulting part of one of the largest consulting firms in the country, to what extent have Watson Wyatt consultants been encouraging clients to shift to hybrid plans?

Mr. Lofgren. We help employers find pension plan designs that fit their objectives. About half the time that might lead to a hybrid design; about half the time that doesn't. And it has to do with the type of workforce the employer has and their concept of equity.

If an employer has and wants a career workforce and they want to focus on retirement income, we will tend to advise a traditional final average, plan that has perhaps 1.5 percent of retirement income at 65 for each year of service. That type of design happens to allocate about 80 percent of the benefit to 20 percent of the people.

For employers that are looking to have a plan design that has a more flexible workforce or more mobile workforce, or that has a philosophy that a dollar of benefits is a dollar of compensation, such an employer will tend more toward thinking that if I give a value that is $5,000 to each of two employees rather than $1,000 to one and $10,000 of value to the other, that is fair and meets the attraction or retention needs.

So we do not actually go out and advocate let's put in a hybrid plan. We go out and talk to employers about finding a design that meets the needs of their workforce.

The CHAIRMAN. I will ask Dr. Schieber and then ask Mr. Woyke if you agree, and this is in regard to a question that I asked Ms. Ferguson in the first panel. You say that the cost savings realized by employers converting to hybrid plans are mostly from the elimination of the early retirement subsidies. Couldn't employers simply eliminate the early retirement subsidies in their plans without converting them to cash balance plans? And if so, why don't they do it this way?

Mr. SCHIEBER. Philosophically, they could certainly do that. But if you go back and you think about how I characterized the plans in terms of our cost analysis, the cost cutters, the cost-neutral plans, and the cost increasers, if you are looking at changing your plan and you need to reduce the costs for whatever set of business contingencies you are facing, it is likely you are in a business that has changed somewhat since you originally put your plan in place, and you may want to revisit the fundamental structure of the plan.

These plans do have features that affect the kind of workers that you attract and your ability to retain them. They affect the rate at which people leave when they reach retirement age. So the structure can become quite important.

If you are one of these employers who is shifting a plan on a cost-neutral basis, if you simply reduce the early retirement incentives, you wouldn't have a vehicle to plow the money back into the plan.

And if you are a cost-neutral shifter and you are reducing the early retirement incentives, that means that you are plowing the money back into the plan.

Those employers in our survey told us that cost was not the issue that was driving their—that was not the driving motivation for the type of change they introduced. They said to us that the motivating thing for them was the ability to attract and retain workers. They were trying to put the money back in, but take out the early retirement incentive.

The cost increasers have taken out the early retirement incentive, but they have actually plowed back additional money into their plans. And I would think that you would certainly not want to preclude people from changing their plans and making the overall plan more generous than the old plan.

The CHAIRMAN. OK. Mr. Woyke.

Mr. WOYKE. I agree, and I want to add that this is illustrated by my chart, because there is one early retirement incentive that you can't take out of a traditional plan, and that is the one at normal retirement age. And if you are trying to attract older employees and retain older employees, you want to give them an opportunity to work longer, and that means beyond 65. Employees have legitimate expectations of getting meaningful benefits for the whole career that they choose to work. And that is the reality of why there are cash balance plans it is—it is not just cost savings. It is redesign that is driving this trend, and that design favors older workers. It does not discriminate against them, in my opinion.

The CHAIRMAN. Dr. Schieber, you said that hybrid plans are not in contribution holidays to any greater extent than traditional defined benefit plans, and we have heard the opposite from other people. How can we sort out this different assessment of the funding statuses of the two types of plans?

Mr. SCHIEBER. Well, I think one of the things we need to do is we need to substitute evidence for anecdote. Certainly we can find cases—and they have been written up in the press—of companies that were in contribution holidays and they have adopted a plan change, and it has been reported that they will extend their contribution holidays.

There are public disclosure documents that plans have to file. Now, what we have done in looking at this issue is we have compiled a list as comprehensive as we possibly have been able of plans that have been converted from traditional plans to hybrid plans. We have gone back and we have collected 5500 data—or gotten 5500 data from the Department of Labor that is filed each year by each pension plan with the IRS and the Department of Labor. And we have done some retabulations on all of the plans that we could identify that have been converted from a traditional plan to a hybrid plan, and we have compared them to the universe of remaining traditional plans.

Now, we believe that you ought to be looking at what is going on in the universe if you want to understand what is going on kind of in general. If you are concerned about particular cases, it is fine to look at particular cases, but you need to be—we all need to be, I think, very careful about extending the results of one particular case to the general.

The CHAIRMAN. You talk about employers trying to coordinate the provisions in their retirement plans with public policy on retirement. Do you think requiring that employers offer any employees affected by conversion a choice of staying in their old plan or moving to a new plan one that would serve or harm public retirement policy goals?

Mr. SCHIEBER. Well, if we look at what is going on in our society right now, we have an aging population. We know that it is going to pose challenges to our Federal retirement system, both Social Security and Medicare, and there is debate about how big a challenge it will be, but there is nobody that argues that it is not going to pose a challenge.

This year we are beginning to implement an increase in the Social Security normal retirement age. Last year, I believe it was, the Senate actually voted to increase the Medicare eligibility age. There are things underway in this society that suggest that workers ought to work longer.

If we required that employers who are changing from a traditional plan to a hybrid plan offer the old plan incentives to everybody who has been covered under the old plan, we are going to leave in place those early retirement incentives that exist in the current plan for another 30 or 40 years. And it seems to me that that is going contrary to where it is public policy is trying to go on the one hand, and it is also leaving in place for employers incentives and strategic plan designs that fit an old employment model that they have come to the conclusion no longer fits their future employment needs.

So I think you are just hide-bounding yourself with a system that is bound in the past, and we really ought to think very carefully about doing that to our economy.

The CHAIRMAN. Now, here is a very pointed question either you or Mr. Lofgren can answer, or maybe both of you will want to, and it is some criticism of research suggesting that the cost story that you tell is rosier than reality because Watson Wyatt seems to implement a disproportionate number of pension equity plans that behave more like final average pay plans. And so your sample of plans is biased in a way that misrepresents the true cost reductions going on in most plan conversions. Is there any bias in your study?

Mr. Lofgren. As Dr. Schieber said, across the broad group of both cash balance and pension equity, the percentage of plans that were cost savers was 45 percent. If we look at the cash balance plans alone, the percentage—and this is the first time this information has been stated publicly, so anybody who had an opinion on this is just guessing, the percentage for cash balance alone of cost savers is 45 percent. The percentage of pension equity plans that are cost savers is 44 percent. I would regard that as not being a bias by including the two as one group.

The CHAIRMAN. Well, then, let me ask you something that maybe gives you a chance to retaliate. You have read what the critics say, as I have. So what do you think the motivation is, then, if they say your plan is biased and, as you just stated it statistically here, you feel that it is not?

Mr. Lofgren. In many ways, a cash balance plan and traditional defined benefit plans are two sides of a coin. On a number of attributes, the advantages to one are the disadvantages of the other. A pension equity plan in its design is a lump sum portable plan which works for mobile young employees. But it is also a final average plan like a traditional plan trying to also work for mid-career employees and older employees as well.

So I would simply regard it was a reasonable surmise, but it was incorrect. The percentage of cost savings are the same on both.

The CHAIRMAN. OK. Do you want to comment, Dr. Schieber?

Mr. SCHIEBER. There has been a great deal written about these conversions. It took us a long time—Eric would tell you much too long, Mr. Lofgren—much too long to put this report together, and that is mostly my fault. This was very hard work.

When I went into this study, when we started this work, because of everything I had read, I was of the opinion that the pension equity plans would prove to be far more generous in the overall conversion cost considerations than the cash balance plans. It is just not there in the data, and we are following the data. And I think a lot of people have preconceived notions or they have embedded concepts because of what they have read in the press. The data simply do not support the credence of what we have been reading.

The CHAIRMAN. Now to Mr. Woyke. You are a tax attorney and an enrolled actuary, and I know that this is probably an unfair question, but fair in the sense that it doesn't involve you personally.

There have been published reports that actuaries have made very cynical remarks at meetings about cash balance conversions. Those remarks cause a lot of concern to all of us. Could you please comment on that? Without going into detail, you know what I am talking about.

Mr. WOYKE. Yes, I certainly do, and the appropriate actuarial authorities I understand are investigating to see if there is any breach of ethical standards.

The comments chiefly refer to the fact that employees might not notice cutbacks in the level of plans if the plan was being switched at the same time, and were taken out of context to imply that employers were trying to fool their employees. I think that is why they generated the controversy.

Many of the comments were taken out of context in meetings either the enrolled actuaries' meeting or American Bar Association meetings. I was not at those meetings, and I really can't comment on the context. All I can say is that certainly the position of the U.S. Chamber of Commerce and the position of Towers Perrin and my position is full disclosure to all employees of the effects of the change, the more, the better, and certainly we would disagree with those comments.

The CHAIRMAN. Can you tell us, Mr. Woyke, why early retirement subsidies are not considered part of normal retirement benefits currently?

Mr. WOYKE. That goes back to ERISA, and at that point it was decided that we had to choose which benefits for which you had to provide legal protection. It was decided that the normal retirement benefit should be protected and that the early retirement benefit

wouldn't have to accrue in the same way. In other words, you could have no early retirement subsidy until you reached the early retirement age I think the philosophy of Congress was this was something you only give to those who for some reason retire early. It is not actually part of the accrued benefit.

I believe this is your question, and that is why it is not protected by law.

The CHAIRMAN. Do employers ever start or remove a 401(k) plan in connection with a conversion to a cash balance plan? And if so, what are they trying to accomplish?

Mr. WOYKE. Well, I have never seen one removed. I think usually there is an increase in the rate of match—quite often. I wouldn't say usually. The reason is you are changing the design, and part of that change of design is to incent employees to contribute more to the 401(k) so they will have better retirement benefits. And certainly we have no objection to that.

The CHAIRMAN. Again, referring to Ms. Ferguson of the first panel, whether or not you agree with her that cash balance plans are way stations and that employers will eventually eliminate them, making employees provide their own retirement.

Mr. WOYKE. I disagree. I am not sure I heard her say that. It might be in her prepared remarks. But I disagree. I certainly agree with her that 401(k) alone is not the way to go. I agree with all of the statements she made that pension plans, defined benefit pension plans, are good, and I heard her to say that she would encourage new cash balance plans and a strengthening of the system.

I do disagree with any comments that under current law they are illegal.

The CHAIRMAN. Dr. Schieber wants to comment.

Mr. SCHIEBER. If you go back and you look at the history of pension plans in general, they grew up late in the 19th century in heavy industry. They spread to banking and insurance and then to education in the early part of the 20th century. After World War II, they exploded across the industrial sectors of our economy.

They arose because employers were very concerned about workers getting to the end of their career and not having anything that they could do but keep coming to the office. The fellow that actually established our company in his Ph.D. dissertation that he wrote at Columbia University in 1936 talked about a problem of hidden pensioners, workers who had gotten so old that they were not longer able to do a job, but the employers couldn't in their good conscience throw them out the door because they had been there for a full career.

I don't think that the underlying economics, the underlying motivations, philosophical motivations for setting these plans up before there were tax laws that were favoring them, before there was ERISA, before there was any of this, these motivations have not gone away. I think employers are going to continue to try to help employees meet their retirement needs.

Now, in that context, I think it would be worthwhile at some juncture to step back and look at the relative burden we have placed on defined benefit versus defined contribution plans to see if we haven't tilted too much to the defined contribution side of the equation.

One of the reasons these plans are going away at the rates that you showed on your chart, Mr. Chairman, is because we have tremendously unbalanced the scale. And we ought to go back and look and see whether we don't want to restore some balance.

The CHAIRMAN. Thank you.

Now back to Mr. Woyke. As a matter of policy, if cash balance plans are age discriminatory, why shouldn't every Section 401(k) plan be declared age discriminatory? And what about profit-sharing plans?

Mr. WOYKE. Well, I agree, they are not discriminatory. But the arguments that some lawyers have said is that is due to a technicality in how section 411(b)(1)(H)(i) is drafted. If you define the accrual as the age 65 benefit, younger employees have a few more years to earn interest and, therefore, get a higher accrual. Of course, the value is less because they have to wait that much more to get their benefits, and the two wash out identically.

So, yes, if you follow this argument, then every 401(k), every profit-sharing plan, is just as discriminatory as a cash balance plan.

The CHAIRMAN. If you have two identical employees and one has 30 years of service and another one has 5 years of service, why shouldn't both of them begin accruing benefits immediately after the conversion to the cash balance plan takes place? Why should the 30-year worker have a wearaway or a benefit plateau, as Ms. Sweatt has called it?

Mr. WOYKE. Well, you can design a plan many ways, and wearaway is not an inherent requirement of a conversion to a cash balance plan. Those companies who have had wearaway generally are very concerned about it and provide grandfathers in a number of things where the people who actually experience the wearaway may be 1 or 2 percent of the population.

They have it because that is an unfortunate side effect of trying to design the plan where you can't just do everything for everybody. There will be some who will be better off under the old plan and some better under the new plan.

By and large, my experience and that of my firm has been, that the great bulk of employees don't perceive the wearaway because they are grandfathered. Although it is fairly unfortunate for the affected employees, the wearaway is there to protect them. In other words, if the law didn't require as a minimum the old benefit, there would be no wearaway because they could say, OK, we are just changing your plan to the new formula and that is what you get. But the law says in no way can you amend a plan to decrease what an employee has, including early retirement subsidies with respect to the accrued benefit. That is, in a way, why you have the wearaway, because it was passed into law to protect employees from ever seeing a decrease in what they have already accrued to date.

Sometimes the wearaway is really an actuarial artifact. For example, let's say you have a traditional defined benefit plan and it provides a pension of $1,000 a month, and you have an employee who has accrued that. You now want to change to a cash balance plan—do you have a question at this point or do you want me to go on?

The CHAIRMAN. He is ready to ask a question.
Senator WYDEN. No. Whenever you want.
Mr. WOYKE. OK.
The CHAIRMAN. You go on.
Mr. WOYKE. The cash balance provides a lump sum, and what you are really doing is you are going to the employee and saying that the employee has a choice between this lump sum and $1,000 a month. But the actuarial tables mandated under 417(e) which have a low interest rate—they have to use 30-year Treasuries—would say that the employer's $1,000 a month is worth more than the lump sum. But it may not be. For example, that employee may have just been diagnosed with cancer, and the lump sum is worth more.

Now, most traditional defined benefit plans only provide the annuity. So to do away with wearaway, some companies have come to us and they said, well, that is all right, we will protect the annuity factors so that that employee can take his cash balance, whatever it is, and turn it into an annuity of $1,000 or $1,100 a month if he wants that annuity. And then we have to tell them, no, the law won't let you take away wearaway in that way.

So the point I am trying to make is that this is a very complex situation. It is not designed to punish employees. It happens occasionally. Companies worry about it. I think the law is designed to protect a certain level of benefit. You may want to tinker with it, but we certainly would like the free enterprise system to do that tinkering rather than Congress.

The CHAIRMAN. Senator Wyden.
Senator WYDEN. Thank you, Mr. Chairman.
Mr. Woyke, nobody is talking about changing free enterprise. The heart of free enterprise is good information, good, objective information. I can tell you that the calls I get from Oregon indicate that employees really feel they are in the dark on a lot of this. They read this stuff, and they say this is hocus-pocus. You know, we talk about actuarial values and CPIs and wearaways and the like.

I guess I would like to start by asking you: What kind of grade would you give employers on what you are calling for at the bottom of page 7 of your testimony? At the bottom of page 7 of your testimony you say that it is important that these plans be described carefully and fully to the employees. You state, "They should receive an easily understandable statement of accrued and projected benefits." Do you think that employers have done an outstanding job of doing this? Or would you give them a "needs to improve" grade? How would you rate the job that has been done thus far on this central kind of question?

Mr. WOYKE. Well, it will vary by employers. Some employers——
Senator WYDEN. Just generally.
Mr. WOYKE. Generally, I would say they need to improve or we wouldn't be having these hearings. I think some of the emotional shock came from employees who didn't get the best information, or they wouldn't have been surprised to find out the difference. Instead, earlier on they might have been talking to their employers, maybe even in the design phase. So the answer is, yes, I would say needs to improve. And, by the way, I think employers are improv-

ing. The glare of publicity has caused them to consider design more carefully.

Mr. Lofgren. I would give 90 percent plus of employers an A. But the other 10 percent I would give an F. If you think about it, cash balance plans have been here for 15 years before there was much protest, and employees 10 years ago were just as smart a employees now.

There are a number of employers that have provided individualized information where employees could immediately tell the difference in value. There are some employers who had reductions in benefits and didn't really want to 'fess up to it.

So what you need to do, in my opinion, is address the issue on the 10 percent of employers without giving requirements that catapult the other 90 percent into terminating the plans.

Senator WYDEN. Well, let's go to this question, then, of your judgment that 90 percent have done a terrific job and deserve an A. If I am pronouncing your name right, is it Ms. Sweatt?

Ms. SWEATT. Yes, it is.

Senator WYDEN. Great. Now, you came out, as I understood it, in response to the chairman's questions, you came out against the idea of these individualized benefit statements that we just heard one of your colleagues at the table say they were being given out. So it seems to me that maybe there is a calculus problem of how you get to 90 percent doing an outstanding job if we have just had a witness from an organization representing many employers say that she is against the very thing that you have said employers are doing well. So I find that a little bit troubling, but let me just ask you a question, if I could.

You have cited the expense associated with these individualized benefit statements and said, well, employees could just get more generic kind of information and that would be sufficient. How do they get the information they need in this key kind of transition period unless you give them something that is essentially individualized?

In other words, I don't think it passes the smell test to just say let's go on out and give them this generic statement and then they are supposed to, you know, act like they have got law school training and actuarial background and the like and sort through all this.

So I want to give you a chance to set the record straight, but I will tell you, I find this curiouser and curiouser as we get into it because one of your colleagues just said employers deserve an A because they are giving out these individualized benefit statements. I heard you say you oppose doing that. Tell us exactly then what you would favor that would be of some value to the individual employee who is not in a position to wade through all this legalese at the key time of transition. That is what I am interested in because, you know, your colleague there said, oh, we can be hidebound and can't think about yesteryear and the like. We have got to get people information in order to deal with this transition. And I would like to have an opponent of these individualized benefit statements tell us exactly what you think the workers should get during the transition.

Ms. SWEATT. OK. Senator, I think first, to start off, it is not necessarily that we are an opponent of individualized statements. What we are trying to get to is a compromise that provides employees the information that they need to make a decision or to understand what truly has happened and yet does not put severe administrative burdens on the plan sponsor.

So what we are really trying to find is something that hopefully meets both needs without providing it. So really what we are talking about is doing detailed illustrative examples that take out a lot of the variables that are more individual by nature.

So when I talk about variables, I mean a person has had a qualified domestic relations order or we have a company that we acquired that there might be a service-based offset there, or you have a rehire that came in under a rehire rule that was very different than what we are operating under today.

Those scenarios, what they do is they create hand calculations, so 15 to 20 percent of your calculations end up being manual. That is a severe administrative burden, and yet I don't know that you are adding that much value to that employee to explain to them the QDRO offset that they had 10 years ago, again.

So, really, what we are focused on is how can we create these illustrative examples that really go across different pay grades, different service grades, different types of employees, without having to get into the nuances of every individual's situation. We even had a contributory plan back prior to the 1980's. So every single one of those people is now a hand calculation because you have to figure out where that piece plays into cash balance, an old plan, and all of that. That is very difficult when you are trying to do projections, you are trying to convert, and you are trying to get employees to understand the new plan.

So, really, what we are looking for is what is the best answer for employees. We strongly believe that we can get there through these illustrative examples that really cross all these different types of scenarios.

Senator WYDEN. I know what you are against at this point, but I really don't know what you are for that will be of some real value to the employees, because the employees who have called us, they have gotten a lot of these illustrations and the like and folks can't wade through it. So I hope that you will reconsider your statement here today. You have a variety of Senators across the ideological spectrum who think that it is time to empower the individual with good information to make these choices, and you have essentially come out against that today. You are against individualized benefit statements, and you are for something else.

I hope that you will reconsider your position because I don't think it is going to cut it to just hand out, you know, a bunch of illustrations. I am prepared to take Dr. Schieber's view. Times have changed and, you know, nobody is talking about clinging to yesteryear here. However, it does a tremendous disservice to the workers of this country to essentially leave them in the dark and say, well, let's give them some illustrations.

Even this panel, we have exposed the inconsistencies right here on this panel. We have had Mr. Woyke say that there needs to be improvement. The witness sitting next to him said let's give em-

ployers an A because of the work they are doing, 90 percent, and citing individualized benefit statements, and then you, Ms. Sweatt, come along and say you are against individualized benefit statements and we ought to just give people some design.

Ms. SWEATT. Senator, I think—we are against it as making it a matter of law saying that every employer has to do this. Some can't administratively do that.

I think also an important point is the statements are wrong 6 months later. So if you have an interest rate fluctuation of 1 percent, you have provided information specific to an employee that is now misleading; whereas, if you do illustrative examples you can really cross more of a spectrum, provide even more information, without getting so specific. We are never going to get to what was a true benefit reduction that employee had. It will always be the wrong answer from an individualized perspective.

Senator WYDEN. There is no quarrel about the fact that interest rates change and the like. But, clearly, to not have a measuring point at a time when there is a transition gives employees no real lodestar. I would be very comfortable if you gave people individualized information, cited the assorted variables that can change, like interest rates, put it in something resembling English so that people could sit around their kitchen table and actually sort it out for themselves.

I don't think that is asking too much here. I mean, that strikes me as a very practice, modest step. We are not talking about imposing vast new mandates on employers in this country. We are talking about what is essentially the fuel that makes the free enterprise system work in this country, and that is good, objective information.

Mr. Chairman, I think what you are doing here is extraordinarily important. I don't have any other questions at this point, but I want to assure you that I intend to work very closely with you, and as with all the work that goes on here at the Aging Committee, it is done in a bipartisan way, and I look forward to pursuing it with you.

The CHAIRMAN. Yes, you have been very cooperative and very energetic in pursuing the work of this committee, and obviously, as we prepared for this hearing, we will continue to work together, and I thank you very much.

I am not going to ask any more questions. Usually, after a hearing, it is pretty easy to summarize, and it is not very easy after this hearing. Frankly, I do not hear a lot of agreement. I think I heard things with the first panel that I agree with and also partly agree with some things that I heard here at the second panel that I agree with.

I think I have concluded that each group is very sincere, each point of view is very, very sincere. I think it is clear that better information is needed to advise participants of the magnitude of changes being made in their retirement. However, I am not certain of the best way to provide that information. We just had a discussion of that here as well. Very sincere points of view on both sides. So I suppose as we go down this direction we would conclude that obviously any suggestions are appreciated.

Too much information sometimes is just as bad as too little, and after hearing from the first panel participant, Mr. Bruggeman, I am very wary of arbitrary calculations. I am not convinced that a benefit wearaway should be allowed in cash balance conversions, though from listening to you folks here in this second panel, there is clearly no consensus on that.

Treasury Department regulations specifically permit wearaways. I made reference to that before. And at times, the Treasury Department has even directed employers to wear away participants' benefits. In fact, Treasury has used this device just to cut back people's benefits, which is troubling as well. On the other hand, there might be some situations where a wearaway in the non-cash balance conversion would be appropriate, such as mergers of acquisitions. I have not made up my mind about this, and I am open to ideas.

We have been waiting for the Treasury Department to give us their views on cash balance plans for over a year. Every time we have asked them about it, they tell us something like it is really very complicated or we are working on it.

The people at Treasury are practically the smartest people in town. Take my word for it. [Laughter.]

At least they are powerful. Let's leave it that way. So I don't understand why it would take over a year for them to tell us what they think about cash balance plans.

But from the standpoint of being impatient, I am sending a letter today to Secretary Larry Summers, Secretary of the Treasury, asking him for the administration's conclusions regarding these plans. Clearly, changes are needed to protect the interests of participants, and we need to have Treasury's view in order to have legislation that will balance the interest of the participants and the plan sponsors, maybe even to make a determination if we finally need legislation, because maybe Treasury has a lot of power to do something about this on their own.

We are not doing the plan participants any favors if we overregulate and suffocate what is left of the defined benefit pension system. The actions that we take have to be fair and not extreme.

I am going to close with a reference to a Washington Post editorial, September 6 of last year, and it is on display over here. You can see there it is called "The Worlds of Pensions." It is about the cash balance plans and IBM.

Since this editorial was published, IBM improved their plan by giving choice to twice as many employees as previously had that option. Obviously, I applaud them for being a corporate good citizen in acting this way, doing the right thing. Not every employee at IBM may be happy, but I think more are happy now than before.

But attention should be directed to the closing thought of that editorial. "Efforts to protect workers with new regulations are fraught with danger. IBM claims that three-quarters of its competitors operate no pension plan." The emphasis added is mine: "If new regulations push more companies down that path, the retirement security of American workers and the national savings rate will be the loser."

Now, that has got to be an overriding concern as we think of this. In fact, it is an overriding concern through all this hearing. It is not an easy thing for Congress to deal with. There are

positives and negatives. I don't always agree, as you probably know, being a Republican, with a lot of Post editorials. But that is really a good thought. We must make plans fair to participants, but we must also be careful not to push more companies down the path where they would be inclined to freeze their defined benefit plans. That would be bad for all of us in the long run, especially for those participants.

As I said to the first panel, I hope you folks will be cognizant of the fact that people beyond Senator Wyden and the Chairman may ask you questions in writing, and we would keep the record open for 2 weeks.

I thank you very much for your participation. It has been a long hearing, but a very important subject, and the meeting is adjourned.

[Whereupon, at 3:26 p.m., the committee was adjourned.]

APPENDIX

AARP Responses to Questions

Question. You referred in your remarks to the "rate of benefit accrual" referring to benefits which commence at age 65. Some pension plans calculate benefits based on final average earnings of the participant. However, the final average earnings of the formulas calculated as an annuity commencing at age 65, provide a declining benefit for participants who work past age 65. Bearing that in mind, would you say pension plans using a final average earnings formula are age discriminatory? Why or why not?

Answer. Plans that meet the rules for post-normal retirement age accruals will not violate the age discrimination laws. Under section 4(i) of ADEA, section 204(b)(1)(H) of ERISA, and section 411(b)(1)(H) of the Code, any defined benefit plan—including one that provides benefits calculated with reference to the participant's compensation paid over his or her last years of employment—is prohibited from providing a declining rate of benefit accrual because of age. A special rule is provided in each of these provisions of post-normal retirement age accruals. Under the special rule, the continued accruals after normal retirement age, required by the general rule, may be offset (but not below zero) by either the actuarial equivalent of in-service distributions or the value of actuarial increases in the normal retirement benefit resulting from delayed payment. Accordingly, under the special rule for post-normal retirement age retirements, there are three possible defined benefit plan designs:

- the plan may provide for the suspension of benefits pursuant to section 203(a)(3)(B) of ERISA, in which case a participant must continue to be credited with benefit accruals during his or her post-normal retirement age period of employment at a rate that is not reduced directly or indirectly because of age;
- the plan may provide for normal retirement benefits to commence at normal retirement age, in which case a participant's continued benefit accruals during his or her post-normal retirement age period of;
- employment may be offset (but not below zero) by the actuarial equivalent of the in-service benefit payments that the participant receives during that period; or
- the plan may increase the benefit payable to the participant upon his or her later retirement by the actuarial value of the normal retirement benefit that would have been payable to the participant at normal retirement age had he or she retired on that date, in which case the participant's continued benefit accruals during his or her post-normal retirement age period of employment may be offset (but not below zero) by the increase in such benefit.

Because the offsets permitted under the special rule may never reduce a participant's continued accruals below zero, the actuarial value of the retirement benefit provided to a defined benefit plan participant who retires after normal retirement age must include the value of the participant's normal retirement benefit increased by no less than the full value of the continued accruals required to be provided to the participant under the general rule. *See* Prop. Treas. Reg. §1.411(b)-2(b)(4).

Under current law, defined benefit plans, unless subject to one of the specific narrow exemptions set forth in the statute, simply not be designed or operate to credit participants with benefit accruals at a rate that is reduced because of the participant's attainment of any age either before or after the normal retirement age described in the plan. If the formulas to which the committee refers provide a declining benefit directly or indirectly because the participant continued to work after normal retirement age, those formulas violate section 4(i) of the ADEA, section 204(b)(1)(H) of ERISA, and section 411(b)(1)(H) of the Code.

Question. You recommended in your testimony that companies be required to offer transition benefits in conversions to cash balance plans. You also state that you believe cash balance plans are per se discriminatory. If cash balance plans are per se

discriminatory, and there is no remedy under the Age Discrimination in Employment Act (ADEA) for such a violation, then why should companies be encouraged to provide transition features in their plan? Wouldn't they just fall back into an illegal trap after providing that mandated benefit?

Answer. To our knowledge, virtually all cash balance pension plans have been established as modifications (commonly referred to as "conversions") to existing defined benefit pension plans. When these conversions occur, the potential for age discrimination exists in two distinct areas.

First, age discrimination can occur if older employees experience a "wear away" of their benefits immediately after the cash balance conversion. This problem has occurred in numerous cash balance conversions and is discussed in detail in our written statement and in our February 24, 2000, comments to the Internal Revenue Service (at pages 34–37). Briefly summarized, a "wear away" occurs when the opening balance in the newly-established cash balance plan is less than the accrued nonforfeitable benefit earned by a participant under the previous defined benefit plan. This is invariably a function of an employee's age because age is always a determinative factor (even if not the only factor) in whether and to what effect employees (most often older, longer service employees) have an accrued benefit which is greater than the opening balance established under the cash balance plan. As a result, older employees may often accrue no benefits for years under the new cash balance plan (until their hypothetical accounts exceed the amount of the accrued benefit under the old plan formula).

The "wear away" of benefits for older workers is perhaps the most severe form of age discrimination that occurs in cash balance conversions because the affected employees literally accrue no benefits for years. In order to eliminate this age discrimination, some employers have offered "transition benefits" to older employees that either reduce, or eliminate, the "wear away." Since any "wear away" is a facial violation of the ADEA, we believe the law should be clarified to prohibit wearaway. However, if it is possible for employers to provide "transition benefits" to eliminate this form of discrimination, then such an approach should also be examined.

Second, it is also true that AARP believes that under current law age discrimination likely occurs as a result of the age-based reductions in benefit accruals in cash balance plans themselves. This is a separate problem, unrelated to the conversion process, which appears to occur in virtually all plans and is discussed in detail in our written statement and in our February 24, 2000, comments to the Service (at pages 23–34). Both of these critical issues—the "wear away" and the age-based reductions in accruals—need to be addressed in a systematic fashion to ensure that older workers are not deprived of pension benefits because of their age. Any comprehensive framework that permits cash balance plans to continue should include appropriate transition rules to protect workers, particularly older workers.

Question. It could be argued that if cash balance plans are per se discriminatory then they are illegal and should be required to "unconvert".

Since retirement plans are inherently based on age, they are subject to the Age Discrimination in Employment Act's (ADEA) "disparate treatment" theory of discrimination rather than the "disparate impact" theory. If retirement plans were subject to the disparate impact theory, any decision affecting a retirement plan, other than to increase benefits would result in a violation of the Act. Such a requirement would be inconsistent with our voluntary pension system which allows plan sponsors to terminate a plan at any time, subject to certain fiduciary and funding rules. Are your arguments a recommendation to make the "disparate impact" theory applicable to retirement plans?

Answer. Based on accrual rules that generally govern defined benefit plans, the rate of accrual in a typical cash balance plan decreases based on the age of the participating employees, all other factors (such as salary and service) being equal. This feature is directly at odds with the explicit statutory language that prohibits "the reduction of the rate of an employee's benefit accrual, because of age. . .." It is not true, however, that the only solution to this apparent violation of the ADEA is for a plan to "unconvert" (i.e. revert back to its previous defined benefit plan formula). It may be possible, for example, for a cash balance plan to weight its accruals so the rate does not decline based on age.

Both the disparate treatment and disparate impact theories are recognized methods of proof in establishing violations of the ADEA. Either method of proof may be applicable to an alleged ADEA violation involving a pension or retirement plan. For example, in *AARP* v. *Farmers Group, Inc.*, 943 F.2d 996 (9th Cir. 1991), the plaintiffs used the disparate treatment method of proving that an employer's practice of discontinuing retirement contributions and accruals at age 65 violated the ADEA. Simply because both methods of proof are available, however, does not mean that all decisions affecting benefits in a retirement plan violate the ADEA. Only those

decisions that adversely affect older workers are likely to lead to challenges under the ADEA. While many aspects of retirement plans are based directly on the age of the participants, those decisions do not raise the specter of an ADEA challenge for the simple reason that they do not ordinarily adversely affect older participants in the plans. Only when decisions based on age adversely affect older workers, or when ostensibly neutral decisions have an adverse impact on older workers is the ADEA implicated.

Question. If, as you said in your testimony, you believe that cash balance plans as currently designed are per se discriminatory, what changes would you make to the way that cash balance plans are designed so that they would not be considered discriminatory?

Answer. As we have stated, based on accrual rules common to defined benefit plans, it is a mathematical fact that, absent other offsetting factors (*e.g.*, increasing compensation with respect to a compensation-based benefit formula), a cash balance plan with a uniform hypothetical allocation and interest credit rate will provide lower benefit accruals to employees solely as a function of their age. As a consequence, the typical cash balance plan design causes the plan to violate the OBRA '86 proscription (from legislation originally sponsored by Senator Grassley) against reducing an employee's rate of accrual on the basis of age. As we have noted, however, this does not mean that the cash balance format should automatically be discarded. Rather, cash balance plans can and should be brought into compliance with the age discrimination laws.

To bring cash balance plans into compliance, their benefit accrual formulas have to be redesigned to increase—within the confines of the backloading rules—the accruals provided to older employees. The increased accruals could be derived from increases in the hypothetical allocation or the interest credit rates, thereby age-weighting the formula, or simply from the provision of additional accruals to older employees directly without disturbing the basic uniform hypothetical allocation or interest credit rate formula of the plan.

As one alternative, the Service could provide guidance to cash balance plan sponsors on the structure of age-weighted hypothetical allocation or interest credit rate formulas in the form of a safe harbor. Such a safe harbor, we will refer to it as an "age-balanced safe harbor," would permit cash balance plans to satisfy the requirements of section 411(b)(1)(H) of the Code by incorporating a non-uniform hypothetical allocation or interest credit rate formula that produces a uniform benefit accrual pattern.

Specifically, the cash balance plan's hypothetical allocation or interest credit rate would increase with age. The rate of increase would be the amount necessary to offset the decrease in benefit accruals that otherwise would result on account of an attainment of any age. However, the rate increase could not be so great as to cause the plan to be incapable of satisfying any of the backloading rules of section 411(b)(1)(A) through (C) of the Code. There may be different ways to structure such a safe harbor, and the Association would welcome further discussions.

Another option that has been put forward is to grandfather workers under the traditional defined benefit formula, or to give employees the choice of remaining under the old plan formula. While these options do not address the fundamental illegality of the cash balance plan design, they do address the adverse impact on older longer service workers that occur in a conversion to a cash balance plan. For that reason, a solution that includes a choice option—preferably at the time of employee termination—or "grandfather" option should also be pursued.

Other proposals have called for, in essense, splitting the plan into two parts: a pre-conversion benefit (part "A") and a post-conversion benefit (part "B"). The new benefit would then be based on a "A" plus "B" formula. Such an approach, while dealing with some issues, such as wearaway, does not deal with other issues, such as the violation of the age laws inherent in a cash balance plan. In addition, under such an approach, older longer-term employees are still faced with a significantly undervalued "A," since that part of the benefit is based on the least generous years under the old plan formula. In addition, the older worker, who is closer to the normal retirement age under the plan, will (absent any transition relief) also be facing the least generous time under "B," the new cash balance formula. As a result, the "A" plus "B" formula provides the older worker with the least generous parts of both the old and new plan designs. Some have suggested—as one option to improve the "A" plus "B" format—an indexation of the benefit under "A" (e.g., for wage increases that the employee earns over time) to ensure a benefit under the pre-conversion "A" that is fairer and more consistent with the original defined benefit plan promise. Such an approach recognizes, at least in part, the unfairness to older workers of a cash balance plan conversion. This approach will generally not keep them whole, however, and thus is less protective than a "grandfather" or "choice" option.

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AARP would be open to other ideas that would remedy the adverse impact on older workers in a cash balance conversion.

KAREN FERGUSON RESPONSES TO QUESTIONS

Question. In your testimony you stated that pay and interest credits should be added to hypothetical cash balance accounts at rates which "do not discriminate against older workers". Could you please elaborate on this point? Specifically, do you believe that the same rate can be used for all participants or would you consider this age discriminatory? If different rates are used, why wouldn't that be interpreted as being age discrimination also?

Answer. If companies use cash balance plan formulas that are age weighted and integrated with Social Security for new, younger employees, they should also use these formulas for older, longer-service employees previously covered by the traditional plan.

Question. You recommended in your testimony that companies be required to offer transition benefits in conversions to cash balance plans. However, you also state that you believe cash balance plans are per se discriminatory. If cash balance plans are per se discriminatory, and there is no remedy under the Age Discrimination in Employment Act (ADEA) for such a violation, then why would companies be encouraged to provide transition features in their plan? Wouldn't they just fall back into an illegal trap after providing the mandated benefits?

Answer. Our concept was that the proposed legislation would effectively create a "safe harbor" from the age discrimination laws (and reversion tax) for those plans opting for choice or the alternative approach.

Question. Your belief that plans are per se discriminatory should lead to the conclusion that they are illegal and should be required to "unconvert".

Since retirement plans are inherently based on age, they are subject to the Age Discrimination in Employment Act's (ADEA) "disparate treatment" theory of discrimination rather than the "disparate impact" theory. If retirement plans were subject to the disparate impact theory, any decision affecting a retirement plan, other than to increase benefits would result in a violation of the Act. Such a requirement would be inconsistent with our voluntary pension system which allows plan sponsors to terminate a plan at any time, subject to certain fiduciary and funding rules. Are your arguments a recommendation to make the "disparate impact" theory applicable to retirement plans?

Answer. The legality of the conversions pre-dating the effective date of the new legislation would continue to be determined by the outcome of pending administrative and judicial proceedings.

Question. In your testimony, you said that you believe cash balance plans as currently designed are per se discriminatory, what changes would you make to the way that cash balance plans are designed so that they would not be considered discriminatory?

Answer. Cash balance plans are per se discriminatory by design only as long as they are deemed to be defined benefit plans. Treating them as defined contribution plans would solve the age discrimination problem.

Question. Should cash balance plans be prohibited from offering lump sum distributions?

Answer. As a matter of policy, annuity payments are preferable to lump sums. However, without full inflation adjustments for annuities, we are reluctant to categorically oppose all lump sum payments.

AMERICAN BENEFITS COUNCIL RESPONSES TO QUESTIONS

Question. Please explain in more detail why you oppose individualized benefit statements.

Answer. The American Benefits Council (the Council) recognizes the desire on the part of some Members of Congress to require that individualized information be provided to participants in the event of cash balance conversions. We at the Council have spent countless hours analyzing the issue and attempting to develop an individual statement regime that would be helpful to employees and workable for employers. These deliberations have led us to conclude that individualized statements are neither the most helpful form of disclosure for workers nor practicable for employers to produce. Rather, as discussed below, we believe that illustrative examples plus prose descriptions will more effectively provide workers with the information they need to understand the change to a cash balance pension design, and will avoid

the substantial burdens and potential for misinformation that are associated with individualized statements.

The individualized statements contemplated in many of the cash balance bills would require employers to provide (1) calculations as to the dollar amounts of employees' accrued benefits at of the date of conversion, (2) projections of employees' personal benefit levels as various points in the future and (3) comparisons of individual employees' future benefits under both the old and new pension designs. The preparation of potentially tens of thousands of such individualized statements in the weeks or months surrounding a cash balance conversion (as much of the legislation would require) would not be possible absent the dedication of truly extraordinary amounts of human and financial resources by employers. Even if were possible to produce these statements in a systemized fashion via computer, such statements would require employers to gather and verify a substantial amount of employee data and would be complicated and expensive to produce. Yet for many employees (typically 15 to 20 percent of a large employer's workforce) such statements cannot be produced via computer. This is because employer computer systems do not contain many of the personal circumstances and factors—such as qualified domestic relations orders (QDROs), offsets from another retirement plan, prior leaves of absence, grandfathered benefits from an acquired company and/or periods of service abroad, to name but a few—that are critical to determining individual employees' accrued pension benefit levels. Rather, calculation of individual accrued benefit amounts depends upon employer personnel manually assembling this information and factoring it into an individual's pension calculation. Today's large employers simply do not have the benefits personnel to perform this manual task for thousands of employees in the timeframes envisioned by the legislation. Indeed, we fear that attempts to comply with such an individualized statement requirement could result in substantial inaccuracies, a clearly counterproductive result for both employees and employers alike.

The Council also fears that individualized projections and comparisons of future benefits, a component of many bills' individualized statement requirement, could prove misleading for workers. Such individualized projections and comparisons would have to be based on assumptions regarding various factors—future pay increases, future interest rates or an employee's retirement date (to say nothing of the assumption of continued employment by the employee). Even a small change in one of these assumptions (which is very likely) can produce actual results substantially different from the projection or comparison contained in the individualized statement. Thus, while individualized statements are likely to give employees a sense of certainty about future benefit levels, these statements are by their very nature likely to differ substantially from actual benefit outcomes. This false sense of certainty is not helpful to the employee in his or her retirement planning and could easily lead to misunderstandings between employees and employers.

For all of these reasons, the Council believes that the most effective way to provide information to employees about how the conversion to a cash balance plan will affect them is through an extensive set of illustrative examples that demonstrate how various representative types of workers will fare under the new plan relative to the old plan. These extensive examples would illustrate the effects of the conversion on workers of different tenure, age and pay and would show how the two plans would compare for these categories of workers at different points in the future. These extensive illustrative examples should be accompanied by a description in words that explains the effect of the amendment on the different representative groups of workers. This disclosure regime—extensive illustrative examples plus prose descriptions—would provide employees with helpful information about how workers like them will be affected by the conversion while avoiding the misleading nature of personal benefit estimates and the extraordinary employer burden associated with production of individualized statements.

Question. One of the witnesses on the first panel seemed to suggest that when a plan is converted from a traditional final average pay plan to a cash balance or other hybrid arrangement that plan participants' accrued vested benefits can be actually cut back in the form of a wear away and because they would not earn the benefit they expected at the time they expected to earn it, i.e. they would most likely have to work additional years to be paid the same benefit from the plan. Would you agree with that characterization?

Answer. Let us take each of the two assertions referred to in this question in turn. The first is that plan participants' accrued vested benefits can be cut back as a result of a conversion to a cash balance plan. This chacterization is factually incorrect. A provision of current law, referred to as the anti-cutback rule, provides legal protection for benefits that an employee has accrued as of the date of a cash balance conversion. Employers may take no action that cuts back or reduces these benefits

that have already been earned. Any wear away or benefit plateau effect that a plan participant might experience would not reduce these previously accrued benefits but rather could slow the accrual of additional future benefits.

The second assertion is that because cash balance plan participants may not be earning the benefits they had expected to earn under the prior plan, they would have to work additional years to achieve an equal level of benefits. Depending on the facts of the particular cash balance conversion it is indeed possible that workers may have to work longer to achieve the same benefit they had expected to earn *in the future* under the prior plan. This need to work longer to achieve the previously expected future benefit level may be due to a benefit plateau (wear away) period, a lower accrual rate under the new plan or the elimination of additional early retirement subsidies for future service. The group of workers affected in this way is usually limited due to the fact that employers typically provide substantial transition assistance to longer-service workers who will not benefit from the conversion on a going-forward basis.

Question. Again, a representation was made on the first panel that employers are funding their pension plans for "projected benefits" and so they could pay workers whose plan was converted a portion of their expected (projected) benefit. Would you agree that employers fund for projected benefits or that plan participants should be or can be vested in their expected benefits?

Answer. In funding their defined benefit pension plans, employers do take into account projections as to what the future liabilities of the pension plan will be. In many cases they are required to do so. Thus, it is not inaccurate to say that employers fund for "projected benefits." The purpose of such funding, however, is to ensure that pension plans contain sufficient assets to pay benefits *when eventually earned.* Requiring employers to vest plan participants in projected or expected benefits would reduce the assets available to pay benefits actually earned. An inability to pay such earned benefits would not only undercut workers' retirement security but could also expose the Federal Government to financial obligations via the Pension Benefit Guaranty Corporation's guarantees. Moreover, requiring payment of projected benefits would also substantially change employers' pension funding incentives. If employers knew that some portion of their pension contributions would be required to go to payments to workers in excess of pension promises, they would be discouraged from contributing funds to the plan beyond the legal minimums. This would, in turn, further undermine plan funding and increase the risk of loss to both plan participants and the federal treasury.

It is true that employers "could pay workers . . . a portion of their expected (projected) benefits" as was stated on the first panel. An employer "could" increase pension or other benefits today, just as an employer "could" increase salaries. This is not a question of whether the employer "could" do so' the panelist is really suggesting that the Federal Government should mandate that the employer "*must*" provide benefits beyond those that were earned. In effect, such a mandate would be little different from the Federal Government telling employers that they must give all employees a retroactive pay raise for services that have already been performed. In fact, the retroactive pension mandate would be worse because it would fall exclusively on those employers who had done what the government encouraged them to do—voluntarily maintain retirement plans and fund them conservatively.

Finally, we must also recognize that the calls for payment of projected benefits stem largely from the fact that, due to market performance in the 1990s and more stringent funding rules enacted by Congress in 1987 and 1994, a number of large pension plans have built up substantial surpluses. Yet, to some extent these surpluses are temporary and act as a cushion should market conditions change, as, in fact, they have of late. It would be imprudent of the government to require employers to make payments beyond promised benefits from these surpluses. Such a mandate would leave plans with less buffer against the vagaries of the bond and equity markets and could threaten employers' ability to meet obligations to future beneficiaries.

Sylvester Schieber Responses to Questions

Question. During our hearing you said that employers generally do a good job of disclosing to their employees the effect of a conversion to a cash balance plan on their expected retirement. But you also said that some employers do a very poor job. Do most of those employers who you believe do a "good job" provide individualized statements comparing the benefits under the old and new plans? If not, could you please reiterate why you believe they are doing a good job?

Answer. I believe that the companies that are doing a good job do provide individualized statements. From my conversations with our consultants who work in this area on a regular basis, I estimate that this encompasses at least three-quarters of the plans that are being converted to hybrid plans.

Question. Do many employers provide detailed, personalized financial information to their participants when a plan converts from a traditional final average pay plan to a cash balance plan? Can you give us an estimate on what percent do provide such statements?

Answer. In cases where employers do project accruals under prior an replacement plans, they generally also provide some sort of modeling device so workers can set their own assumptions on pay growth and other important factors that affect accruals under the alternative plans. Our sense is that about half of the employers who provide benefit statements provide such modeling capability. This type of projection and modeling capability is particularly important in cases where workers are given the opportunity to choose between plans.

Question. If they do not, please give us the reasons why they don't.

Answer. One of the major problems with providing such projections is that it results in an unfair comparison. In most cases where plan sponsors provide and estimate of a future benefit under a traditional defined benefit plan, they assume that current pay will persist until retirement. To do otherwise may crease unwarranted expectations and simply cause problems that are unnecessary. In fact, the benefit projections included in the Social Security benefit statements that are now being distributed nationally are developed in this way. In a plan where ultimate benefits are based on final pay or pay indexed the way pay is indexed in Social Security benefit determinations, using flat pay projections does not distort the ultimate value of benefits in a traditional plan. But projecting a cash balance account assuming a flat rate of pay will result in a misleading overestimate of pension value relative to final pay.

Where employers are not projecting benefits under the old plan, they frequently will provide somewhat more significant grandfathering for workers relatively close to retirement or who might be significantly adversely affected by the transition to the new plan. Their individual benefit statements will include projected accumulations for workers converted to the new plan including their starting balances and future accumulations under alternative scenarios.

Question. Is it possible to give us an estimate of the cost of providing such information, in terms of both money and man-power for large plans, such as those with which your firm contracts?

Answer. To a certain extent costs tend to be relative and precise estimates are hard to generalize. We have had clients with over 100,000 employees where both the prior and new plans were relatively straightforward where we have provided both a benefit statement and supporting modeling capability for significantly under a half million dollars. If the old and new plans are complicated and workers are given wide-ranging modeling capabilities that let them model savings inside and outside their plans to meet retirement needs under free ranging earnings, work-life, and life expectancy scenarios, it gets much more expensive. We estimate that most plans with as few as 1,000 active participants can probably implement effective individualized communications programs for something less than the first year change in plan accounting costs associated with the elimination of early retirement subsidies in the prior plan. This does not imply that plan sponsors always or often save these costs in the conversion to new plans, but it does give a sense of the relative cost of communication versus a plan feature that is typically modified in the shift to a hybrid plan.

Small employers tend to substitute personnel costs for communications and modeling expense. That is, smaller employers are more likely to rely on less sophisticated modeling capabilities but will have counselors who can help workers understand the implications of the plan changes for themselves.

Question. Are you familiar with any firms that provided individualized statements? If so, how long did it take them to aggregate the data and run the software needed to produce the individualized statements?

Answer. We have many clients who have provided such statements. We strongly recommend that workers should understand the full ramifications of plan changes affecting their benefit programs. In the typical project, benefit statements can be distributed within two to three months from the beginning of the project.

Question. The Internal Revenue Service believes that most plans can "push a button" and get any information they want about the plan or its participants. If that is true, why can't plans provide the comparative financial information for the participants affected by these conversions? What are the liabilities for the plan sponsors?

Answer. It is impossible for plan sponsors to control what the Internal Revenue Service believes. What the IRS believes and reality are often two different things. The fact is that many companies do not have fully integrated human resource systems that include the pay and service histories and workers' demographic profiles that allow instantaneous benefits estimates on a worker-by-worker basis. The companies keep their records in formats and across the files in ways that allow them to fulfill their business needs. The payroll files that are necessary to meet periodic payroll needs and earnings statement needs for end of year purposes do not have to include information on date of hire, date of birth, and other similar information required to estimate retirement benefits. Merging of such files may be done only periodically, and often by staff who have other dedicated duties. It is not uncommon that some pieces of information needed to do a precise calculation of benefit entitlement will be missing or miscoded. In the usual operation of a plan, erroneous data is typically corrected when benefits are ultimately claimed. At that point, age, service, and pay records are reviewed and verified as part of the benefit determination process.

For the purposes of running a business, misstatement of information needed to compute pension benefits is not immediately important. For purposes of estimating relatively precise benefit entitlements, precise information becomes much more important. Providing a worker with wrong information presents a number of problems. One is that such a worker might make a wrong decision when presented erroneous information. Over-estimates of benefits can create expectations that are converted to future benefit claims. Underestimates of benefits can create aggravation on the part of employees and immediate demands for record correction outside the framework under which such records would more naturally be cleaned.

Question. In discussions about the controversy surrounding conversions to cash balance plans, the concept of mandating transitional benefits is often recommended. To what extent, if any, are companies concerned that generous transitional benefits they might like to provide, or might be mandated to provide, could inadvertently cause them to violate the nondiscrimination rules and backloading rules.

As I respond to this, I must remind readers that I am an economist by training and not a lawyer or an actuary working on plan valuations. Most of the problems that you refer to in the question above relate to early retirement subsidies in traditional plans and their elimination in the transition to hybrid plans.

It is more than a theoretical possibility that imposing a transition provision on hybrid plans that requires sponsors to overlay the prior accrual pattern of a traditional plan on a hybrid plan would result in both nondiscrimination and backloading problems. These would occur as the value in the hybrid plan was stepped up in correspondence with the step up in value of a subsidized benefit in the prior plan. The step up in value would be of such magnitude for highly compensated individuals that it would likely create nondiscrimination problems in some instances. This problem could be eliminated by limiting the requirements on transitional benefits to non-highly compensated workers but that would create its own set of inequities and ironies. The inequities would result because workers in practically similar situations would be treated differently. It would be ironic because it is probably the highly compensated workers affected by the transition to hybrid plans that have brought the problems related to plan shifts to policymakers' attention.

Economically, the added "accrual" in the hybrid plan from a benefit step up at "early retirement" eligibility and the "subsidy" in the traditional plan would be identical. One way this problem might be resolved would be to require that plan sponsors offer annuities under hybrid plans with the same subsidy structure prior to normal retirement as they provided in their traditional plans. Some people would complain that this would create a benefit of greater value if provided as an annuity than taken as a lump sum. But that is exactly the situation with benefits provided under traditional plans under current law. Why these subsidies are not considered added accruals at the point they are granted puzzles me as an economist. Alternatively, why we would worry that they create accrual problems if provided in lump-sum form but not in annuity form puzzles me. I see the increments in value in either case as equivalent increments in value.

From an economic perspective, saying that an early retirement subsidy does not cause backloading or nondiscrimination problems but that an incremental step up in an account payable as a lump sum benefit does makes no sense. The Congress must have some reason for drawing this distinction and, if it does, could undoubtedly modify the law to exempt increased accruals in hybrid plans that mimic annuity subsidies at specific ages in traditional plans.

JOHN WOYKE RESPONSES TO QUESTIONS

Question. In discussions about the controversy surrounding conversions to cash balance plans, the concept of mandating benefits is often recommended. To what extent, if any, are companies concerned that generous traditional benefits that they might like to provide, or might be mandated to provide, could inadvertently cause them to violate the nondiscrimination rules and backloading rules?

Answer. Companies are concerned because of plaintiffs' arguments in the Onan litigation. The employees in that case contested the plan design on the basis of the backloading rules. The particular design gave the employee the greater of an annuity purchasable by a cash balance account or a traditional career-pay annuity formula. The employees argued that the plan was disqualified because the combined "greater of" formula could not meet the accrual rules. Each formula, standing by itself, would meet an accrual rule, but providing the greater of two different formulas could result in one formula being applying one year and the other the next, making accrual rates uneven.

The employees won the Onan plan qualification case and the plan was disqualified, although the court did not rest its decision on this particular objection. The problem is that, if the backloading rules were interpreted in such a fashion, no plan could give an employee an "after the fact" choice of the better of two benefits.

Nondiscrimination rules could also pose problems. Often the employees who complain most about loss of benefits are among the "highly compensated" group. Preserving their rights to generous subsidies and accrual rates could disqualify the plan. This could be a problem even if all current employees were grandfathered, as the existing employees are often higher paid simply by virtue of their longer service and experience.

Question. Since retirement plans are inherently based on age, they are subject to the Age Discrimination in Employment Act's (ADEA) "disparate treatment" theory of discrimination rather than the "disparate impact" theory. If retirement plans were subject to the disparate impact theory, any decision affecting a retirement plan, other than to increase benefits would result in a violation of the Act. Such a requirement would be inconsistent with our voluntary pension system which allows plan sponsors to terminate a plan at any time, subject to certain fiduciary and funding rules.

Do you believe that arguments that cash balance plans are per se age discriminatory are tantamount to a recommendation that the disparate impact theory be made applicable to retirement plans?

Answer. No. The argument that I have heard advanced most often is that such plans are discriminatory because of Section 4(i)(1)(A) of ADEA, which forbids" . . . in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age . . ." Those who believe cash balance plans are inherently age discriminatory interpret "benefit accrual" and "rate of benefit accrual" to refer to an annuity commencing at normal retirement age. They base this argument on the fact that ERISA and the Tax Code, for unrelated purposes, define the term "accrued benefit" in such terms.

I disagree with this argument, which involves a hyper-technical (and, in my opinion, incorrect) reading of the text of the law. Furthermore, their reading creates a distinction between those who are under normal retirement age and those who are above normal retirement age, and favors the former over the latter. As I pointed out in my testimony, traditional defined benefit formulas penalize those who work beyond normal retirement age.

There are people, however, who believe that a disparate impact theory should apply to ADEA. Without getting into the details, I cannot see how such a theory could be rationally applied in the pension context. As I have stated before, traditional defined benefit plans penalize those who continue to work after normal retirement age. Is ADEA to be read to outlaw these plans, too? Given the complexity of pension design and the fact that pensions are inherently age-related, disparate impact could be found somewhere in any design.

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE

FOR THE
SELECT COMMITTEE ON AGING
UNITED STATES SENATE

HEARING ON
CASH BALANCE PLANS

MONDAY, JUNE 5, 2000

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE

FOR THE SELECT COMMITTEE ON AGING
UNITED STATES SENATE

HEARING ON CASH BALANCE PLANS
MONDAY, JUNE 5, 2000

ERIC joins with the Members of the Senate Select Committee on Aging in the hope that continued discussions will lead all sides to appropriate evaluation and practicable resolution of issues that have been raised in the context of conversions of traditional defined benefit plans to new hybrid plan designs such as cash balance plans.

The issues involved are complex and have been made more complex by a debate characterized more by heat than light. At stake is whether employees will continue to have defined benefit plans available to them as part of their retirement portfolio.

THE ERISA INDUSTRY COMMITTEE (ERIC)

ERIC, a nonprofit association, is the only organization in Washington, D.C. that represents exclusively the employee benefit plan interests of America's largest private sector benefit plan sponsors. ERIC's members provide comprehensive retirement, health care coverage, and other economic security benefits directly to some 25 million active and retired workers and their families. Thus, ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

ERIC represents the interest of major employers who provide plans to their employees, not the interests of consultants or other who market them. Instead, ERIC's members must determine what plan designs best meet the needs of the businesses they run and the employees they hire, sponsor those plans for their employees, and coordinate those plans with the total compensation and benefits packages they offer their employees.

MAJOR EMPLOYER SPONSORSHIP OF DEFINED BENEFIT PLANS

Currently, most of ERIC's members include a defined benefit pension plan in the compensation and benefits package provided to employees. Indeed, ERIC members' plans probably comprise the largest concentration of defined benefit plan participants in the private sector. Whether ERIC members will continue to sponsor defined benefit plans in the future, however, may be determined by the outcome of the current debate over new hybrid defined benefit plan designs such as cash balance plans.

Already there are many occasions in the business operations of ERIC members where defined benefit plans are not established or continued, or where existing plans are not extended to new groups of employees, because of the complexity and impracticability of the rules imposed on these plans.

Many employers still want to provide their employees a secure, guaranteed, defined pension benefit as part of their compensation and benefits package, however. A significant number of major employers also have determined that the traditional defined benefit plan no longer meets the needs of their businesses or their employees. These employers have turned to hybrid defined benefit plan designs. If irrational and impracticable rules are imposed on hybrid defined benefit plans, these plans will cease to be attractive. Simply put, if employers cannot offer a defined benefit plan that meets their business needs and suits their workforce, they very rapidly will turn to other benefit arrangements, which, while more popular at the moment, may be less secure in the long run.

ERIC believes that rational and practicable answers can be found where there are real problems in the conversion to hybrid plan designs and is ready to work diligently with the Committee toward that end. We believe in the defined benefit system, and we want the defined benefit design option to continue to be available to employers to provide security for their employees in the future.

Accordingly, this statement considers positive proposals for action, provides principles that we believe should be followed in any action taken by Congress and the federal agencies, and provides insight for the Committee on the easily foreseeable effects of proposals that have been put forward that we believe are misguided.

CASH BALANCE PLANS AND THE CURRENT DEBATE

Although some would have the Committee believe that cash balance plans are inherently bad plans, they are not. In fact, cash balance plans have proven very popular with most employees. Studies by the Society of Actuaries and by Watson Wyatt Worldwide[1] show that most individuals emerge from a cash balance plan with greater benefits than they would from a comparable traditional defined benefit plan. The issues that have been raised primarily concern the impact of conversions of traditional plans to cash balance plans on a narrow band of employees.

Many of the objections raised are not relevant to cash balance plans at all but rather to the elimination of future accruals toward an early retirement subsidy. In today's economy, where companies are scrambling for skilled workers it makes no sense for those companies to pay a skilled worker a bonus to walk out the door early. In the current economy, many employers will eliminate early retirement subsidies regardless of whether they also are converting a traditional plan to a cash balance plan.

As this Committee knows, the law already protects the employee's right to receive an early retirement subsidy with respect to benefits he or she had already earned, even if the employee only later meets the age and service requirements for early retirement. As a result, any amendment to the plan can eliminate only that portion of any subsidy that would have been attributable to future earnings. This protection applies to hybrid plan conversions in the same way it applies to other plan amendments. A

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[1] See "A Benefit Value Comparison of a Cash Balance Plan with a Traditional Final Average Pay Defined Benefit Plan," by Steve J. Kopp, Richard Joss, and Lawrence J. Sher; and "The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans," a Watson Wyatt Worldwide Research Report.

voluntary pension system cannot function if employers cannot change their plans regarding future employment service. Employers must be able to respond to changing workforce and competitive circumstances or their businesses will die.

Allegations also have been made that employers are converting to cash balance plans simply in order to save money. Studies published by Watson Wyatt Worldwide and Pricewaterhouse Coopers[2] of actual conversions show that this generalized accusation simply is not true. While some conversions have resulted in lower costs, benefits costs after the conversions that have occurred to date more often have been the same or higher than before. The primary reason employers are converting their plans is to attract and retain the workers they need to compete.

Setting aside for a moment transition issues that have been raised in the context of conversions from traditional to hybrid plans, it is evident why so many employers who need to attract and retain employees have been turning to cash balance and other hybrid plans in recent years. These plans –

- Provide benefits that are more understandable than those under traditional defined benefit plans,
- Unlike 401(k) plans, provide for automatic employee participation,
- Unlike 401(k) and other defined contribution plans, shield the employee from investment risk,
- Unlike 401(k) and other defined contribution plans, provide guaranteed benefits,
- Benefit mobile employees by providing benefits that generally are more portable than those available under traditional defined benefit plans,
- Benefit older workers because the value of their benefits continue to grow at the same rate before and after normal retirement age,
- Benefit women and others whose work careers are shortened or interrupted by child rearing or other family responsibilities,
- Expand job opportunities because employees will be able to change jobs without giving up the opportunity to earn the bulk of their pension, which is loaded in the years just before retirement under traditional pension formulas,
- Must offer annuities to participants and survivors,
- Facilitate coordination with other benefits because the benefit is stated as a lump sum amount, easing the employee's task of planning for retirement, and encouraging retirement savings.

In the modern workforce, if cash balance plans did not already exist, we would be busy inventing them.

AGE DISCRIMINATION IN EMPLOYMENT ACT

In a May 9, 2000, letter, Equal Employment Opportunity Commission Chair Ida L. Castro, after describing "the complexity of the legal issues and the extent of the disagreement about the meaning of the current law," concluded that it, "would be premature for the Commission to issue guidance at this point in time as we need to review a myriad of issues."

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[2] See "The Unfolding of a Predictable Surprise," above. Also see "Survey of Cash Balance Conversions," Pricewaterhouse Coopers "Cash Balance Notes," May 2000.

In fact, pronouncements by the EEOC or even final decisions by the district courts or courts of appeals, all of which are years away, will not put an end to the debate over how the discrimination laws apply to cash balance plans. The stakes are simply too great for plaintiffs' lawyers and for plan sponsors to settle for anything short of a Supreme Court decision or legislative clarification by Congress. The uncertainty both for plan participants and plan sponsors during many years of prolonged litigation does not serve the public interest.

If Congress were to take any action at all regarding the application of the Age Discrimination in Employment Act (ADEA) to cash balance plans, it should be to affirm that cash balance plans and other hybrid defined benefit plans are not inherently unlawful under the ADEA or under the age discrimination provisions of ERISA and the Internal Revenue Code. This would –

- prevent years of litigation that could strangle the defined benefit plan system;
- prevent an unfavorable court ruling that would throw the retirement plans of millions of workers into disarray;
- discourage arguments parallel to those being proffered in the cash balance debate from generating law suits against numerous other forms of benefit plans.

There are compelling foundations upon which Congress could base such an action. For example,

- An ADEA-protected employee, age 45, who goes to work for an employer with a cash balance plan but takes a job with a different employer before reaching retirement age will leave with higher benefits than he or she would under a comparable traditional defined benefit plan. There is no age discrimination in providing such benefits.
- An employer has not violated ADEA if an employee is laid off at age 54 for reasons unrelated to age. An employer has not violated ADEA if an employee's pension plan is changed at age 54 as a result of a plan conversion affecting other employees of all ages. In addition, whereas the employee's prior salary and other benefits can be reduced without violating ADEA, the employee's accrued pension benefit already is fully protected under current law.
- Arguments have been presented that benefits under a cash balance plan are reduced on account of age because the value of an annuity deferred to normal retirement age that could be purchased by an account balance of a certain amount credited to an employee of a younger age is larger than the comparable deferred annuity that could be purchased for an older employee. This is not age discrimination; it is simply a function of the time value of money.
- No one contends that a 401(k) or other defined contribution plan that produces equal lump sum benefits for two workers of different ages with identical service and compensation histories discriminates against the older worker because his or her lump sum will buy a smaller deferred annuity. It would be a strange anomaly if Congress were to decide to outlaw defined benefit plans that mimic perfectly lawful defined contribution plans.

- ADEA Section 4(i)(1)(A) and the corresponding provisions of ERISA and the Internal Revenue Code were adopted by Congress in 1986 to stop the then common practice of reducing or eliminating benefit accruals at normal retirement age. Critics of cash balance plans argue that "rate of accrual," as used in those statutes, means the rate at which the annuity at normal retirement age grows from year to year before normal retirement age. Cash balance plans are inconsistent with these statutes and that definition of "rate of accrual," the critics argue, because the interest credits that each year's pay credit will earn out to normal retirement age are treated as accruing in the year in which the pay credit is given. Thus a $1,000 pay credit is worth more to a younger employee because she receives more years of interest credits than an older employee who by definition is closer to normal retirement age. This argument is seriously flawed in two respects.

    - First, interest credits out to normal retirement age are treated as accruing in the year of the pay credit only because the IRS has determined that this method of accounting for interest credits avoids "backloading" issues. If interest credits are treated as accruing in the year in which they are earned, the so-called age discrimination disappears.

    - Second, by defining "rate of accrual" in terms of what happens up to the time of normal retirement age, the critics' argument takes cutbacks in benefits tied to reaching or passing normal retirement age out of the reach of the statutes. But addressing *that* issue was precisely what Congress was attempting to do in 1986.

WEAR-AWAY

If Congress considers eliminating wear-away, we urge it to do so with knowledge of the breadth of the proposed action so as to minimize the harmful and unintentional effects of that action. ERIC is ready to engage this Committee in a full discussion of the issues involved so that, whatever the outcome of the debate, all sides may be assured they are acting in the best interest of the long range stability and attractiveness of the defined benefit system.

Wear-away has been an accepted method of equalizing benefits for many years. For example, Treasury Regulation Section 1.401(a)(4)-13(c) outlines both a "wear-away" and an "extended wear-away" method to be used by defined benefit plans in complying with new nondiscrimination requirements. Similarly, Treasury Regulation Section 1.401(a)(17)-1(e) describes the same wear-away methods to be used by plans to comply with the reductions in compensation that can be taken into account for benefits and contributions that were required by the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1993. Accordingly, the Treasury Department and the Internal Revenue Service have for many years not only permitted wear-away, but sometimes have required it as a method for making the transition from one benefit structure to another.

Employers also have used "wear away" in various circumstances. For example, when an employer with a less rich benefit formula purchases a company with a richer formula, wear-away has been a tool to equalize benefits so that, in the future, employees working side by side with similar salaries and service histories will have similar benefits.

By using a "wear away" approach, an employer also can prevent an employee's benefit from being bifurcated each time the plan – or the employee's employer – changes. By using a wear-away approach, the employer recognizes the employee's past service in the new plan benefit. When the new benefit becomes greater than the benefit under the prior plan, the employee need track only the new, higher benefit. In addition, the employer is relieved of the administrative complexity of tracking multiple prior benefit formulas as well as the difficult task of informing employees about multi-tiered benefits.

Under defined benefit plans, the employee generally is better off when he or she can consolidate service under a single plan. If wear-away is not used when a plan is amended or when the employee changes employers through a business transaction, the employee's benefit under his or her prior plan likely will be frozen at that time, and the employee will start accruing benefits under the new plan as though he or she were a new hire. At the end of his or her career, an employee could thus have several benefits, each with different formulas and different service records, and would face the complicated task of adding them all together to compute his or her total retirement package. Often the sum of these different benefits will be significantly smaller than one benefit based on total years of service.

Wear-away may also occur in the context of conversions to cash balance plans because of –

(1) the relationship between the accrued benefit under the prior (traditional) plan and the opening account balance (under the cash balance plan);

(2) interest rate fluctuations; and

(3) early retirement subsidies.

To illustrate the first of these factors, as well as related ADEA issues, consider an example used by the critics of cash balance plans. Two employees, one age 35, the other 45, have identical compensation and service histories. On the date of the conversion to a cash balance plan, their life annuity benefits at normal retirement age (e.g., 65) under the traditional defined benefit plan also would be identical. But when their annuity benefits are converted to lump sums for cash balance purposes, the older employee has a larger starting balance than the younger employee because the former's annuity benefit is discounted over only a 20-year period (age 45-65) versus a 30-year period (age 35-65) for the younger employee. As a result, the older employee might have a three-year wear-away period before his or her benefits under the cash balance plan "catch up" with the employee's protected benefit from the traditional plan, while the younger employee might have no wear-away period.

The result? If both employees quit two years after the conversion, the older employee gets a larger lump sum benefit than the younger counterpart with an identical history of earnings and service. If instead they both work another 20 years, retiring at 55 and 65 respectively, their lump sum benefits are identical, although the older employee, because of his or her shorter life expectancy, is entitled to a larger monthly annuity on an immediate basis.

At each point when benefits become available -- and which therefore are the only points that matter -- the older employee is better off. The older employee's three-year wear-away reflects not age

discrimination but rather the fact that his or her benefits during and after the conversion and wear-away are never less than the benefits of the younger employee.

Regarding the second factor, because interest rates fluctuate, participants can move in and out of wear-away even though the employer has taken no further action whatsoever.

Regarding the third factor, if an employer eliminates an early retirement subsidy, the employee's protected benefit under the prior plan (which included the subsidy) may be greater than the benefit under the new plan without such a subsidy. We believe the Committee should draw a distinction between this situation and the situations outlined above. An early retirement subsidy is a diminishing benefit that is not part of the participant's normal retirement benefit. For example, if an employee is eligible for an unreduced annuity at age 55, the value of that extra benefit is reduced each year the employee remains on the job after age 55, and disappears entirely when the employee reaches normal retirement age.

This is an important point. We believe that many of the complaints that have been presented to Congress are not directed, in fact, at cash balance plans but at the elimination of early retirement subsidies on future accrued benefits. As we have said before, in today's economy, for many employers who are scrambling to find skilled workers, it makes no sense whatsoever to provide skilled employees with an incentive to walk out the door early. Moreover, a voluntary pension system cannot function if employers cannot change their plans for future employment service. We emphasize that whatever subsidy the employee has earned to date is preserved under current law.

If Congress acts to eliminate wear-away, it *must* exclude early retirement benefits from any such provision. Any other action makes no sense under the law, could deny employers the flexibility they must have to design appropriate benefits for a changing workforce, and is contrary to the interests of the national economy.

If Congress acts to eliminate wear-away, it *must* also make clear that anti-wear-away restrictions do not apply where no conversion has occurred, i.e., where the employee remains under the prior plan formula.

Any proposal to eliminate wear-away must consider these issues.

DISCLOSURE:

Most employers go to great lengths to explain the benefits they sponsor to their employees. This is common sense. The employer offers benefits in order to attract and retain the most qualified workers, and employees will not feel they are getting much in the bargain if they do not understand the benefits available to them. Current law requires employer to provide summaries (Summary Plan Descriptions) that describe benefits in terms the average participant can understand, and any employee can request an accrued benefit statement as often as once a year.

If, however, Congress decides to enact legislation to increase current-law disclosure requirements, legislation that adheres to the following principles would serve the legitimate needs of employees without imposing undue burdens or requirements that employers simply cannot meet.

Requirements that don't recognize the importance of these principles will risk the demise of defined benefit plans as an option for most employers who need to amend their current plans to be more responsive to changing workforce demographics and business conditions.

- *Any mandated notice should be required to be given only to persons reasonably expected to be significantly and adversely affected by the amendment.* It is not unusual for an amendment to affect only a small portion of a very large workforce.

- *Any new notice requirement should make clear that it does not apply where the amendment does not alter the plan's pre-amendment benefit formula and merely gives current participants the opportunity to elect to accrue benefits in the future under an alternative benefit formula.* Where the employee has the right to remain in the old plan, no conversion has occurred. Employers already are required by ERISA's fiduciary standards to provide comprehensive information in participant choice situations.

- *Any new notice requirement should apply only to a significant change, not to a change that might reduce the future accruals of isolated individuals.* Under almost any change, it will be possible to construct a hypothetical situation in which an employee with an unusual work history might suffer a significant reduction in future accruals.

- *Any new notice requirement should require the plan to describe only the principal features of the amendment and their impact on prior plan provisions.* Although a notice of this kind might be required as much as 30 days in advance of the amendment's effective date, an exception should be made for amendments adopted in connection with business acquisitions and dispositions, where a 30-day advance notice requirement will often be impossible to meet. (The special problems of mergers, acquisitions, and other business transactions are dealt with in greater detail below.)

- *Any new notice requirement should not require the plan to provide individual benefit calculations for affected employees, but could require the plan to provide representative hypothetical examples to illustrate the effect of the amendment.* Employers simply do not have the data available to calculate accurate individual benefit statements for all employees simultaneously. In order to make such calculations, the employer must gather historical data on each employee. That data frequently will be in the hands of spun-off divisions or companies or acquired divisions. Moreover, much of it will be on paper files, and calculations would have to be made by hand. Such requirements are for most employers simply a practical impossibility. On the other hand, illustrative examples can provide a wealth of information to employees in a readily accessible and understandable format. The employee can easily compare his or her situation to the most relevant examples and thereby gain the knowledge needed to continue his or her retirement planning.

- *If the plan states the employee's benefit as an account balance, any legislation could require that, within a reasonable period after the effective date, the employee be given a statement of the opening account balance and the employee's accrued benefit under the*

plan before the amendment. However, the legislation should not require the accrued benefit to be stated in a form not provided by the plan; for example, a defined benefit plan that does not offer a lump sum should not be required to state an employee's accrued benefit as a lump sum.

- *Any legislation should not require the plan to prepare individualized projections of participants' benefits under either the amended plan or the pre-amendment plan.* Such projections are highly sensitive to future unpredictable events such as future salary increases, the length of future service, future promotions or demotions, interest rates, and future plan amendments. In addition, many employers simply will not have the data on hand to make such projections. The illustrative examples outlined above will provide employees with more valuable and realistic information because they will be better able to see the impact of different future variables on their own circumstances while recognizing the unpredictability of actual future events.

- *Any penalty for failing to provide a required notice on a timely basis should be limited to an excise tax.* The penalty should not be plan disqualification and/or nullification of the amendment. Excessive penalties not only are wholly disproportionate to the infraction, they will suppress the creation of new defined benefit pension plans and will injure the many participants in the affected plan who would have benefitted from the amendment.

- *Any legislation should apply uniformly to all defined benefit plans.* All employees should be treated the same regardless of whether they work for a large or small employer.

- *A plan should not be required to provide a copy of the plan amendment automatically to each participant.* Some proposals have included such a requirement. A plan amendment is often a highly technical document that will have little meaning for many employees. Employees who want the plan document have the right to request a copy under current law. The plan should not be required to incur the expense of automatically sending a copy to each employee.

- *Any new notice requirement should apply only to amendments first communicated to employees after enactment of the requirement.* Employers should not be expected to satisfy new rules that did not exist when prior actions were taken. Second announcements will only confuse employees, many of whom will assume their plans are being amended again.

MERGERS, ACQUISITIONS, AND OTHER BUSINESS TRANSACTIONS

Plan changes that occur as a result of mergers, acquisitions, and other business transaction should be exempt from new requirements regarding disclosure and wear-away for the following reasons:

- If there is no exception, a buyer may not accept transfers of a seller's pension plans. If the seller's plan is not transferred to the buyer, the seller's employees will suffer – their benefits under the seller's plan will be frozen, and they will not, for example, be able to use their service with the buyer to qualify for subsidized early retirement benefits under the seller's plan.

- It is not unusual for a plan applicable to employees of an acquired company to be amended or terminated. Employees may be moved from a traditional defined benefit plan to a career average plan, a 401(k), or a profit sharing plan -- or from one of these plans to a traditional defined benefit plan. Employees expect changes when they work for a different employer. There is no reason to single out conversions from traditional defined benefit plans to hybrid plans for new and onerous requirements in these circumstances.

- Mergers and acquisitions present special problems that do not arise when a buyer is amending its own plan –

  - The timing problems are severe. The deadlines imposed by the various bills that have been introduced do not recognize the practical problems faced by a buyer when it takes over a seller's plan in connection with a business acquisition.

  - The buyer typically will not have detailed information regarding the seller's plans prior to the transaction.

  - The seller may change the plan just before the effective date of the transaction.

  - It is often difficult for the buyer to obtain accurate and readily useable service and compensation records from the seller as well as information regarding all of the benefits, rights, and features under the seller's plan. This frequently is true even after the effective date of a transaction.

- If the legislation requires the buyer's plan to apply an "A plus B" formula to the employees transferred from the seller, the buyer will be prevented from providing the same benefits to all of its employees (that is, both the employees transferred from the seller and the buyer's pre-existing employees).

- If onerous or impractical requirements are imposed when an individual becomes part of a cash balance/hybrid plan as part of normal business operations, employers will be reluctant to establish and maintain these plans. As a practical matter, burdensome or unworkable requirements that interfere with business operations will encourage employers who already have moved away from traditional defined benefit plans to exit the defined benefit system entirely.

OTHER ISSUES

Some proposals that have been put forward would violate the employer's right to establish, design, and change its plans by mandating specific transition methods such as requiring that employees be provided a choice between the old and new plan when a plan is amended. ERIC adamantly opposes such proposals and urges this Committee to reject them. Such proposals would effectively prevent employers from sponsoring retirement plans for their employees by penalizing employers who have adopted such plans.

Contrary to claims made by critics, factual surveys such as the recent survey by Pricewaterhouse Coopers[3] verify that employers spend an enormous amount of time, effort, and money in devising transition benefits for their employees when they change their plans. Some employers have grandfathered older workers under a prior plan; others have offered a portion or all of their workforce a choice to continue participation in the prior plan or transfer to a new plan; some have provided a bump-up in benefits under either the prior or the new plan, or under both, usually specifically targeted at older workers; others have guaranteed payment of the higher of the benefits derived from two or more benefit formulas and have provided this guarantee for a period of time or on a permanent basis for current employees; some employers have increased benefits under other plans; and others have devised measures appropriate for their own circumstances. In other situations, an employer facing financial difficulties may be cutting back on benefits overall as part of a program of financial survival, regardless of the plan design.

If Congress mandates – or weights the law toward – specific transition methods, it will, at a minimum, present employers with uneconomic and ill-fitting choices and stifle the creativity that U.S. employers need to remain competitive. At worst, it will effectively terminate the voluntary nature of the defined benefit system and will result in the foreclosure of defined benefit plans as a viable retirement security option for the future.

In conclusion, we recognize that Congress has heard strongly-voiced complaints arising from some -- but far from all -- conversions to cash balance plans, and that Congress will want to respond to those complaints. We are pledged to work with you to sift through the many issues involved in order to determine where changes in law might be warranted. We hope that this can be done by taking into account the overall situation and the full ramifications of any decisions. We believe this is essential if Congress is to avoid the problem of enacting even a targeted response that has unwelcome and unintended side effects.

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[3] See, "Cash Balance Notes," May 2000, above.

June 15, 2000

THE
ERISA
INDUSTRY
COMMITTEE

The Honorable Lawrence Summers
Secretary of the Treasury
United States Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Alexis Herman
Secretary of Labor
United States Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Dear Mr. Secretary and Madame Secretary:

The ERISA Industry Committee ("ERIC") understands that the Administration may be preparing to issue a statement of position on issues raised by conversions of "traditional" employer-sponsored defined benefit pension plans to cash balance and other hybrid defined benefit pension plans. Senator Charles Grassley asked for such guidance in a June 5 letter to Secretary Summers, and other Members of Congress have made similar requests in the past.

Much of the current controversy is being driven by a series of careless and distorted media reports that rely more on anecdotes than on facts. Precipitous action by the Administration or the Congress, based on careless reporting and incomplete or inaccurate assertions of "fact," will cause employers that now provide defined benefit plans to change to less secure arrangements. Those changes are not likely to be reversed and will adversely affect the retirement income of millions of working Americans.

Before the Administration acts, we urge you to consider the following:

- **Employers are implementing cash balance and other hybrid pension plans for fundamental business reasons - not to reduce costs.** Members of the baby boom cohort are beginning to leave the workforce, and there are simply not enough skilled workers ready to fill the substantial gaps that are being created.

  In this environment, it is essential that employers have in place retirement plans that enable employers to compete effectively for the limited pool of qualified workers and that encourages longer-service workers to continue working up to, and even beyond, "normal" retirement age. Traditional final average earnings

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The ERISA Industry Committee is a non-profit association committed to the advancement of the employee retirement, health care coverage and welfare benefit plans of America's major employers.

plans with generous early-retirement subsidies no longer appeal to a growing number of employees or their employers. They don't attract new hires, and they bleed the company of talented, experienced employees. This, more than anything else, is driving the trend toward hybrid pension plans.

By contrast, cost reduction is not a motivating factor for most employers that are converting their pension plans to hybrid plan designs. Two recent independent studies of employers that have converted traditional defined benefit plans to hybrid plan designs demonstrate that a majority expect their total retirement benefit costs to increase or to stay the same. Repeated contrary allegations by the media are simply not true.

- **The issues that have been raised are technical and complex; there are no simple solutions to the many questions that have been raised.** Proposals to impose new disclosure requirements for amendments to defined benefit plans and to eliminate "wear away" have been portrayed by their proponents as straightforward, common sense solutions to some of the prominent issues that have been raised. They are not.

  ERIC believes that employees should be adequately informed about amendments to their retirement plans, and has identified possible modifications to the current disclosure requirements that would be both practical and helpful to employees. However, ERIC strenuously objects to impractical disclosure requirements that the vast majority of employers cannot possibly meet. For example, with one exception every disclosure proposal introduced to date would require employers to deliver a statement of accrued benefit to many, and in some cases to all, employees affected by the amendment immediately before or after the amendment's effective date. Employers rarely have all the data needed to complete these calculations. As a result, these disclosure requirements would bar most employers from converting their plans to hybrid designs. In addition, circumstances peculiar to individual employees would require employers to perform anywhere from ten to twenty percent of such benefit calculations by hand. Faced with these obstacles, many employers will have no option but to exit the defined benefit system and provide benefits to employees in some other, less secure way.

  Proposals to restrict or to eliminate the use of "wear-away" as a transition device for plan amendments also are fraught with unintended consequences. For example, if wear-away is not used when a plan is amended or when the employee changes employers as a result of a business transaction, the employee's benefit under his or her prior plan likely will be frozen at that time, and the employee will start accruing benefits under the new plan as though he or she were a new hire. This vastly complicates the retirement planning process because the employee

could ultimately have several benefits, each with different formulas based on different periods of service. In addition, the sum of these different benefits often will be significantly smaller than one benefit based on total years of service.

Wear-away has been an accepted method of equalizing benefits for many years. For example, Treasury Regulation Section 1.401(a)(4)-13(c) outlines both a "wear-away" and an "extended wear-away" method to be used by defined benefit plans in complying with new nondiscrimination requirements. Similarly, Treasury Regulation Section 1.401(a)(17)-1(e) permits the same wear-away methods to be used by plans to comply with the reductions in compensation that can be taken into account by qualified pension plans. Accordingly, the Treasury Department and the Internal Revenue Service have for many years not only permitted, but have actually encouraged, the use of wear-away.

Finally, opponents of cash balance plans argue that such plans inherently violate the Age Discrimination in Employment Act (ADEA) or, at the very least, that conversions of traditional defined benefit plans to cash balance plan designs often lead to violations of the ADEA. ERIC's analysis of these claims is available in our paper "*Are Cash Balance Plans Inherently Unlawful Under the Age Discrimination in Employment Act*", which concludes that such claims are without merit. A copy of our paper is enclosed.

The Equal Employment Opportunity Commission (EEOC) has been reviewing this issue since at least September of 1999. In a May 9, 2000 letter to Senator Grassley, EEOC Chairwoman Ida L. Castro reviewed the complex legal issues and concluded that "[i]t would be premature for the Commission to issue guidance at this point in time as we need to review a myriad of issues arising from the hundreds of charges recently received . . . . Indeed, even if the agencies were to reach agreement about the proper interpretation of the statutory provisions at issue, that interpretation would be contested in court for years to come, leaving both employers and affected employees uncertain of their respective rights and obligations."

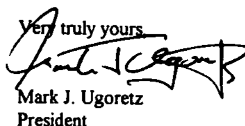
- **Employers will react to unfavorable changes to the law or regulations.** Employers offer retirement and other benefits as a means to recruit and retain qualified workers. If new rules and regulations make it difficult or impossible for employers to modify their plans in ways that they feel are necessary to remain competitive, they will take other steps that are not so encumbered. Some may turn to other benefits arrangements, which, while more popular at the moment, may be less secure in the long run. Others may simply terminate their plans altogether.

- **Onerous new requirements on defined benefit plans will complete their demise.** In 1987 there were more than 111,000 PBGC-insured single-employer defined benefit pension plans in the United States. In 1998, about 42,000 remained. This precipitous decline in the number of defined benefit plans has coincided directly with the onslaught of rules and regulations that have made these plans increasingly difficult – and expensive – to administer. If additional burdens of the type now being proposed are added, the system will collapse of its own weight. The losers will be the 33 million working Americans and their families who currently participate in private employer-sponsored defined benefit plans and who are counting on those plans to provide a secure, predictable retirement income.

We are deeply concerned that we are all too close to realizing the late Senator Jacob Javits' fear of "the damaging frustrations growing out of an irrational regulatory scheme which deters the employer from instituting a pension plan for his employees."

Thank you for taking the time to review our concerns. We will be happy to discuss these and other relevant issues with you in more detail.

Very truly yours,



Mark J. Ugoretz
President

Enclosures

ERIC............ NEWS RELEASE

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FOR IMMEDIATE RELEASE
June 5, 2000

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MAJOR EMPLOYER GROUP CHALLENGES MISSTATEMENTS ON CASH BALANCE PLANS

Members of Congress Urged to "Look Behind the Noise"

Washington, D.C. June 5, 2000 -- Critics' contentions that cash balance pension plans are being adopted by employers primarily to cut costs and that the plans are inherently disadvantageous to older workers "are flatly contradicted by the facts and are being driven by anecdotes and sound bites," said Mark J. Ugoretz, President of The ERISA Industry Committee (ERIC), the association representing the employee benefit plans of the Nation's largest private plan sponsors.

"There has been an extraordinary amount of noise and misinformation regarding cash balance plans and conversions to cash balance plans, particularly with respect to why employers are adopting these plans," noted Ugoretz. "Members of Congress will be pleasantly surprised to find that plan sponsors are adopting cash balance plans to meet employee demands, that they are not cutting their costs when they do so, and that both older and younger workers generally benefit from the changes. Who benefits depends, as it does with traditional final average pay plans or even defined contribution plans, on the choices employees make about their careers. With most employees expected to hold eight to ten jobs during their careers, employers are redesigning their retirement security plans to meet the changing reality," said Ugoretz.

"The fact is, employees seek both portability and security and until now they could only have one without the other. Cash balance plans offer both and could play an even greater role in retirement security than either traditional defined benefit or 401(k) plans," Ugoretz noted.

According to Ugoretz, Members of Congress must understand that:

1) Employers generally are adopting cash balance plans to adapt to changing employee needs and business circumstances -- *not* to cut costs. Survey data repeatedly bear this out, including a new PricewaterhouseCoopers survey in which 70 percent of the respondents said that the overall costs of their new retirement program (including enhancements to 401(k) plans) were expected to be the same or greater in the short-term. And almost as many -- 67 percent -- expected costs to be the same or greater over the long-term.

In instances where companies have reduced costs by adopting a cash balance plan, it is largely due to the elimination of subsidies for early retirement, which typically augment benefits at around age 55. Workers that lose some of the benefit of early retirement in the shift from a traditional plan to a cash balance plan could consider this a benefit reduction, even though those who work until age 65 may receive more from the cash balance plan they would have under the traditional plan.

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MAJOR EMPLOYERS CHALLENGE CASH BALANCE MISSTATEMENTS/ PAGE TWO

"Given the current shortage of talented workers, it is not surprising that many employers can no longer afford to encourage their most experienced workers to walk out the door -- and sometimes go to work for a competitor -- while they're still highly productive," said Ugoretz. This is also consistent with federal policy, which now calls for the Social Security 'normal retirement age' to rise to age 67, he added.

2) Cash balance plans are *not* inherently disadvantageous to older workers. Each individual in a cash balance plan receives the same percentage of compensation pay credit (except for those plans that provide *higher* credits to older workers), and the rate at which interest credits are calculated also is uniform. Critics of this even-handed approach are essentially seeking repeal of the time value of money in complaining that the magic of compounding interest favors younger workers. And in the case of conversions from traditional plans to cash balance plans, the same PricewaterhouseCoopers survey found that 81 percent of employers provided grandfathered benefits and/or transition pay to protect longer-service employees.

Moreover, cash balance plans provide a critically important element of security in workers' retirement portfolios. Consider: contributions are typically made by the employer; the investment risk is borne by the employer; and the benefits are insured by the federal Pension Benefit Guaranty Corporation.

"It's interesting that for many years traditional final average pay defined benefit plans have been criticized for concentrating benefits among those employees who were able to remain with one employer for their entire working careers," added Ugoretz. "We're deeply concerned that opponents of cash balance plans are demanding that employers guarantee for the entire tenure of an employee the benefits that were in place on the day that employee was hired. That's impossible in an economy where companies must quickly adapt to changing employee needs and business circumstances or die."

Testimony submitted today by ERIC to the Senate Aging Committee for the panel's hearing,"The Cash Balance Conundrum: How to Promote Pensions Without Harming Participants.," is available through the "Testimony and Comment Letter" section of ***ERIC OnLine*** (www.eric.org) or by calling the ERIC office.

The ERISA Industry Committee (ERIC) is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers and is the only organization representing exclusively the employee benefits interests of major employers. ERIC's members sponsor plans that provide comprehensive retirement, health care coverage and other economic security benefits directly to some 25 million active and retired workers and their families. The association has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

-ERIC-

ERIC . . . . MEMORANDUM

THE ERISA INDUSTRY COMMITTEE

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ERIC'S PRINCIPLES FOR INCREASED DISCLOSURE REQUIREMENTS

In order to 1) improve employees' understanding of their retirement benefits when a the design of a defined benefit plan is significantly amended (e.g., converted to a cash balance or other hybrid defined benefit pension plan design) and 2) avoid undermining the voluntary defined benefit system, The ERISA Industry Committee (ERIC) believes that any legislation regarding disclosure should adhere to the following principles.

1. **Notice Only to Participants Reasonably Expected to be Affected:** Any mandated notice of a reduction in future benefit accruals should be required to be sent only to persons reasonably expected to be affected by the amendment, not to all participants and alternate payees. Sending mandatory notices to participants who are not affected by plan amendments will not only be superfluous; the notices will needlessly mislead and alarm millions of participants and their families. It is not unusual for a plan amendment to affect only a small number of the employer's employees (e.g. an amendment that affects a specific job category or a single division).

2. **Notice Provided Regarding Significant Changes in Plan Design:** Any mandated notice requirement should apply only to a significant plan change, not to a change that might reduce the future accrual of isolated individuals. In almost any plan change, it might be possible to construct a hypothetical situation where an individual with an unusual fact pattern might suffer a significant reduction in future benefit accruals. Mandated notice requirements should not be based on the possible existence of hypothetical situations that have little chance of occurrence.

3. **Advance Notice:** Any advance notification should be required to describe only the principal features of the amendment and their impact on prior plan provisions. The legislation could require the advance notice to describe all significant amendments to the pension plan provisions, including the plan's basic benefit formula, early retirement subsidies, and optional forms of distribution, as well as any wear-away features. Although a notice of this kind might be required as much as 30 days in advance of the effective date of the amendment, an exception should be made for amendments adopted in connection with acquisitions and dispositions, where a 30-day advance notice requirement is often impractical.

4. **Hypothetical Examples:** Any legislation could require the plan to provide representative hypothetical examples that illustrate the operation of the principal plan features affected by the amendment (such as the plan's basic benefits formula, early retirement subsidies, optional forms of distribution, and any wear-away features). The examples and the assumptions on which the examples are based should not be mandated; the plan administrator should be permitted to select the examples and assumptions that are appropriate for the particular plan and plan amendment. Because the examples and assumptions that are appropriate will vary from case to case, it is not possible for Congress to prescribe uniform examples and assumptions that will be helpful and relevant in all cases.

-MORE-

5. **Individual Statement of Account Balance:** If the plan states the employee's benefit as an account balance, any legislation could require that, within a reasonable period of time after the effective date, the employee be provided a statement of his or her opening account balance as well as the employee's accrued benefit under the plan prior to the amendment. However, the legislation should not require the employee's accrued benefit to be stated in a form not provided by the plan.

6. **No Individualized Projections:** Any legislation should not require the plan to prepare individualized projections of participants' benefits - under either the amended plan or the pre-amendment plan. Such projections are highly sensitive to future unpredictable events - such as future salary increases, future service, future interest rates, and future plan amendments.

7. **Penalty:** Any penalty for failing to provide the notice on a timely basis should be limited to an excise tax, similar to the tax imposed by Internal Revenue Code § 4980B for failing to provide a timely COBRA notice. The penalty should not be plan disqualification and/or nullification of the amendment. The consequences of disqualification and nullification are wholly disproportionate to the failure to provide a notice.

8. **Uniform Application:** Any legislation should apply uniformly to all defined benefit plans. The legislation should not apply solely to large plans, nor should it subject large plans to requirements that differ from those for small plans. There is no legitimate basis for distinguishing between large and small plans in this context. Participants in small plans have the same need for information about their plans as do participants in large plans.

9. **No Copy of Amendment:** A plan should not be required to provide a copy of the plan amendment automatically to each participant. Plan amendments are often extremely voluminous documents that are of little or no interest or value to virtually all participants. Moreover, participants have the right to inspect or obtain a copy of the plan document under current law. In view of this right, providing participants with a description of the plan amendment fully protects their interests.

JCB/DISCLOSURE PRINCIPLES
AUGUST 2, 1999

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ARE CASH BALANCE PLANS INHERENTLY UNLAWFUL UNDER THE AGE DISCRIMINATION IN EMPLOYMENT ACT?

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September 20, 1999

EXECUTIVE SUMMARY

The claim that cash balance plans invariably violate the Age Discrimination in Employment Act (ADEA) is without merit.

1. On its face, a cash balance plan is unquestionably age neutral. Each individual, regardless of age, receives the same percentage of compensation pay credit (except for those plans that provide *higher* credits to older workers), and the rate at which interest credits are calculated also is age neutral.

2. Internal Revenue Service Regulations dictate that, in any given year, both the cash balance plan's pay credit for that year and all projected future interest credits on that year's pay credit up to normal retirement age must be treated as accruing in that year. Thus, the hypothetical contribution on behalf of a 25-year-old employee, including the compound interest credit projected out to normal retirement age, accounts for a higher portion of the annuity that begins at normal retirement age than the comparable contribution on behalf of an older employee who is closer to normal retirement age. Some argue that this results in a discriminatory "disparate impact" on older workers.

3. This IRS-dictated method of accounting is derived from statutory restrictions on the "backloading" of pension plans. With another perfectly logical method of accounting (each year's accrual includes all interest credits earned in that year on the current account balance) the supposed disparate impact on older workers would disappear.

4. If the critics of cash balance plans were correct, Congress must have intended to outlaw all cash balance plans using the IRS's "frontloaded" accounting procedure. In fact, Congress expressed no such intent. Moreover, the "frontloading" approach cited as producing an ADEA violation in cash balance plans has been specifically sanctioned by Congress for certain other defined benefit plans.

5. Defined contribution plans, which are not required to follow restrictions on backloading, clearly cannot be attacked on ADEA grounds as critics are now attacking cash balance plans. Thus, if those critics were correct, one could have two otherwise identical employers, one offering a cash balance plan and one a defined contribution plan, with the same pay credits or contributions and equivalent methods of crediting or calculating subsequent earnings -- the only difference being that one employer was violating ADEA. This makes no sense in terms of the purposes and policies underlying the ADEA.

6. Unlike typical claims of age discrimination, the source of the claim in the case of a cash balance plan does not rest on alleged employer bias against older workers, but rather on IRS interpretations of the restrictions on backloading.

7. In 1988, in explaining proposed regulations dealing with the ADEA issue, the IRS said that defined benefit plans do not violate ADEA "solely because of a positive correlation between increased age and a reduction or discontinuance in benefit accruals or account allocations under a plan."

8. ADEA case law does not support the notion that cash balance plans are inherently unlawful. To the contrary, under prevailing case law, differences in treatment based on factors that are highly correlated with age, such as years of service and levels of compensation, do not for that reason alone amount to age discrimination under ADEA. For example, a compensation policy that awards larger annual salary increases to employees with the lowest current salaries, and early retirement programs that offer monthly supplements as inducements to retire early have been affirmed under ADEA.

9. The ADEA complaints regarding conversions of traditional defined benefit plans to cash balance plans really involve alleged breaches of contract, not ADEA claims.

10. The likelihood that an employee might be subject to a "wear away" because of a conversion from a traditional plan to a cash balance plan typically is a function of length of service, not age.

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September 20, 1999

ARE CASH BALANCE PLANS INHERENTLY UNLAWFUL UNDER THE AGE DISCRIMINATION IN EMPLOYMENT ACT?

In the traditional defined benefit pension plan, often called a final average pay plan, the benefit is an annuity that is based on a formula that takes into account years of service with the employer, some measure of compensation (such as average annual earnings in the last five years of employment), and a multiplier (such as one percent for each year of service). Since annual earnings tend to correlate with seniority or years of service, the largest portion of the annuity benefit typically is earned in the last few years of employment.

Cash balance plans also come within the legal definition of a defined benefit plan, but are structured quite differently, with the result that a much higher proportion of the retirement benefit is earned in the early years of employment. Are cash balance plans invariably illegal under the Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. § 621, et seq., because of the difference in the ways in which the retirement benefits are earned? We think not.

I. The Predicate Underlying The Contention That Cash Balance Plans Are Inherently Unlawful Under The ADEA Is "Frontloading"

Most claims of age discrimination are fairly straightforward. The plaintiff alleges that he was wrongfully terminated -- or not promoted, paid less, or suffered in other ways -- because of his age. The plaintiff offers either direct evidence of discriminatory intent (the employer said, "I don't like old workers") or attempts to prove intentional discrimination through circumstantial evidence, most commonly by the so-called indirect method of proof articulated in

McDonnell Douglas Corp. v. Green, 411 U.S. 792 (1973), and its progeny. For example, a plaintiff might contend that while the employer's stated reason for terminating the plaintiff was nondiscriminatory, perhaps poor performance, the stated reason was a mere pretext for age discrimination because younger co-workers who performed as poorly as the plaintiff were not terminated.

One can readily imagine particular provisions or features of cash balance plans that would be unlawful under the ADEA using this traditional disparate treatment analysis.[1] A cash balance plan that, for example, eliminated allocations to an employee's hypothetical account as soon as the employee reached or exceeded some specified age such as 65 would appear to be on its face age-based discrimination, and, so clearly so, that intent to discriminate could be inferred simply from the fact that such a provision was adopted.

One commentator has gone much farther, however. Under this author's thesis, cash balance plans are inherently unlawful under the ADEA. See Sheppard, "The Down-Aging of Pension Plans," 82 Tax Notes 171 (Jan. 11, 1999).[2] The path leading to Sheppard's conclusion requires a fairly detailed understanding of cash balance plans, the Internal Revenue Code, and the ERISA regulatory framework applicable to cash balance plans.

The starting point is ADEA Section 4(i)(1), 29 U.S.C. § 623(i)(1):

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[1] Besides disparate treatment, an employment practice or policy, although neutral on its face, may be unlawful if it has a "disparate impact" on a protected class and the practice or policy cannot be justified by the employer on grounds of "business necessity." A minimum height requirement, for example, typically disqualifies many more women than men. But this "disparate impact" theory has been widely, albeit not uniformly, rejected in the context of the ADEA.

[2] Sheppard is by no means alone. Several lawsuits challenging cash balance plans have been filed, and various plaintiffs' lawyers, journalists and politicians have weighed in against cash balance plans. But Sheppard was one of the first to do so, and, unlike others, has attempted to justify her position with more than mere rhetoric. Accordingly, this paper focuses on Sheppard's arguments.

> (1) except as otherwise provided in this subsection it shall be unlawful . . . to establish or maintain an employee pension benefit plan which requires or permits –
>
> (A) in the case of a defined benefit plan the cessation of an employee's benefit accrual or the reduction of the rate of an employee's benefit accrual, because of age . . ..[3]

Although they resemble in some respects defined contribution plans, such as the popular 401(k) plans that many private employers offer, cash balance plans are defined benefit plans and regulated as such. Each participant in a cash balance plan has an account that receives in each year of active employment a "pay credit," consisting of a hypothetical contribution corresponding to a stated percentage of annual compensation, and an annual "interest credit" equal to a specified percentage of the cumulative balance in the participant's account. When the participant retires, the account balance is converted into an annuity, as the Internal Revenue Code and ERISA require for defined benefit plans, although many cash balance plans offer a lump sum option. Unlike 401(k) plans, however, the risk of investment is borne by the employer and participants' benefits are protected by the Pension Benefit Guaranty Corporation.

What portion of that retirement annuity is earned or accrued in any one year of employment? If each year's pay and interest credit to an individual's account balance were treated as having accrued in that year, the annual interest credit in the last few years before retirement would, for a person with many years of service, exceed by many fold the combined pay and interest credits in the first few years of plan participation, due to the effect of compounding interest over a long period.

But this method of determining accruals is not used. Instead, the IRS has said

[3] Nearly identical restrictions on age discrimination are found in IRC § 411(b)(1)(H) and ERISA § 204(b)(1)(H). These "mirror image" provisions were enacted as part of the same legislative package in which the ADEA provision quoted in text was adopted.

that. to avoid violations of the statutory restrictions on the "backloading" of defined benefit plans. the interest credit on each year's pay credit in a cash balance plan should be projected out, with compound interest, to the normal retirement age specified by the plan, and the sum of all of that interest should be treated as accruing in the year of the pay credit. The effect of this rule is that cash balance plans are "frontloaded," meaning that a significantly greater proportion of the annuity benefit at normal retirement age is treated as having accrued in the first few years of participation in the plan. When a high proportion of the final benefit accrues in the years immediately preceding retirement, a defined benefit plan is deemed to be "backloaded." Final average pay plans by their very nature tend to be "backloaded." For many years Congress and regulators have been concerned that "backloading" results in little or no retirement benefit for those who participate in the plan for a relatively short period; as a result, the amount of permissible "backloading" is restricted by statute.

A younger employee, by definition, has more years than an older employee before reaching any specified normal retirement age. Thus, the hypothetical contribution on behalf of the 25-year old employee, including the imputed compound interest credit projected out to normal retirement age, accounts for a higher proportion of the annuity that begins at normal retirement age than the comparable contribution on behalf of an older employee who is closer to normal retirement age.[4]

Sheppard concludes from all this that frontloaded cash balance plans violate

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[4] An illustration not involving cash balance plans may be helpful. Suppose an employer gives a 3 percent annual bonus to workers who promise to invest the money in a mutual bond fund until reaching the normal retirement age of 65. A 64 year-old employee with $150,000 in annual compensation receives a $4,500 bonus and one year later, when he reaches normal retirement age, he has $4,770, assuming a 6 percent earnings rate for the fund. A 25 year-old employee earning $30,000 per year receives a bonus of only $900, but when he reaches age 65, 40 years later, the portion of his account attributable to that $900 bonus may be worth $8,000 or so depending on interest rates over the 40-year period of compound growth.

ADEA Section 4(i)(1)(A) because "benefit accruals," or at least the rate at which benefits accrue, necessarily declines as the individual grows closer to normal retirement age. Indeed, so powerful is the time value of money that a disparate rate of "benefit accrual" may exist even when pay credits under the plan are skewed in favor of older employees, e.g., the percentage of compensation awarded as a pay credit to the account of older employees is higher than the percentage awarded on behalf of younger workers.[5]

II. The Anomalies That Would Result From Treating Cash Balance Plans As Inherently Unlawful Under The ADEA Raise Serious Doubts As To The Soundness Of The Theory

To determine whether the Sheppard theory has any merit, it is appropriate to look at (1) the statutory framework and the legislative history of ADEA Section 4(i)(1); (2) the relevant regulations and (3) the case law interpreting Section 4(i)(1) and the ADEA generally. Before doing this, however, three significant anomalies are worth noting.

First, if the Sheppard theory is meritorious, Congress effectively outlawed cash balance plans when it adopted ADEA Section 4(i)(1) in 1986.[6] That Congress had any such intention seems improbable. Cash balance plans use the frontloaded approach only because they are compelled to do so by IRS interpretations of the restrictions on backloading. Further, the frontloading approach that Sheppard sees as producing an ADEA violation in the case of cash balance plans was specifically sanctioned by Congress prior to 1986 for certain other defined

[5] In the illustration in the foregoing note, if the older employee receives a bonus of 4 percent and the younger employee's bonus remains at 3 percent, one year later the older employee's account is $6,360 (the $6,000 bonus plus one year's interest of $360), but this is still less than the account of the younger employee 40 years later.

[6] Section 4(i) (1) was adopted with an effective date for most purposes of January 1, 1988, as part of the Omnibus Budget Reconciliation Act of 1986 ("OBRA").

benefit plans.[7]

Second, defined contribution plans, which function very much like cash balance plans, clearly are not prohibited by ADEA Section 4(i)(1).[8] Indeed, if the Sheppard theory were sound, one could have two otherwise identical employers, one of which adopts a cash balance plan and the other a defined contribution plan, with each plan offering the same annual contributions or pay credits and offering equivalent methods of crediting or calculating subsequent earnings (interest credits), the only practical difference being that the employer that opted for a cash balance plan has done something that is illegal under the ADEA while the other employer has no problem. Such a difference in outcome makes no sense in terms of the purposes and policies underlying the ADEA.

Third, the age discrimination alleged to be inherent in cash balance plans does not reflect an employer's decision to treat its older workers less favorably and is not the product of employer bias against older workers. On the contrary, the source of the alleged age discrimination is a regulatory framework requiring that future interest credits be deemed to have accrued immediately. If the IRS changed its interpretation of the restrictions on backloading, or

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[7] ERISA Section 204(c) and Code Section 411(c) require a defined benefit pension plan that accepts mandatory employee contributions to use a method that is similar to the method cash balance plans use to determine the accrual of employees' annuities at normal retirement age. Under these provisions, the accrued benefit attributable to mandatory employee contributions is defined as the sum of the employee's accumulated contributions (including accrued interest on the basis of prescribed interest rates) projected forward to a normal retirement age. Because they require the use of a frontloaded approach, ERISA Section 204(c) and Code Section 411(c) strongly indicate that, in enacting the age discrimination provisions, Congress did not intend to prohibit cash balance plans from using this frontloading approach.

[8] ADEA Section 4(i)(1)(B), which parallels Section 4(i)(1)(A)'s restriction on defined benefit plans, provides that defined contribution plans are unlawful if contributions to the employee's account terminate or are reduced on account of age. Thus, so long as the employer's contributions are equivalent, it is irrelevant for ADEA purposes that the younger employee-participant in a defined contribution plan will have greater accumulated earnings than the older employee if both work to normal retirement age.

if Congress repealed those restrictions, the ADEA issue disappears.

Standing alone, these anomalies do not obviate the need to examine the statutory framework and legislative history, the relevant regulations, and the case law. However, unless those sources provide compelling support for the Sheppard thesis, and they do not, these anomalies suggest that the thesis should be rejected.

III. The Statutory Framework and Legislative History Are Not Consistent With The Sheppard Theory.

Viewed in terms of traditional age discrimination analysis, the Sheppard theory clearly falls in the disparate impact as opposed to a disparate treatment category. On its face, a cash balance plan is unquestionably age neutral. Each individual, regardless of age, receives the same percentage of compensation as a pay credit, except for those cash balance plans that give higher percentage pay credits to older workers. The rate at which annual interest credits are calculated is also identical, regardless of age. The cash balance plan can be viewed as disadvantaging older workers only because, by definition, they have fewer years than younger workers before reaching the normal retirement age specified by the plan. Yet reading ADEA Section 4(i)(1)(A) as condemning cash balance plans on disparate impact grounds is hard to reconcile with the fact that other parts of subsection (i), adopted at the same time as Paragraph (1)(A), quite explicitly sanction various pension plan design features that unquestionably have a disparate impact on older employees.[9] While no provision of subsection (i) explicitly sanctions

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[9] Paragraph (2), for example, permits pension plan provisions that limit the total amount of benefits that a plan provides and that "cap" the number of years of service or years of participation which are taken into account in determining benefit accruals under the plan. Thus, traditional defined benefit plans may and in some cases do limit credit for service with the employer to the first 25 or 30 years of service, a limitation on benefits that can have an adverse affect (assuming the employer in the past has complied with the child labor laws) only on individuals who are more than 40 years old. Paragraph (5) provides that highly compensated employees (who disproportionately are older employees), whose accruals are reduced in order to comply with the restrictions on discrimination in favor of highly compensated employees, will

the supposed disparate impact of cash balance plans on older workers, it is difficult to fathom why a Congress that expressly sanctioned considerable disparate impact intended at the same time to outlaw cash balance plans on disparate impact grounds.

The legislative history does not indicate that Section 4(i)(1)(A) and the mirror image provisions of the Code and ERISA were adopted for the purpose of outlawing cash balance plans. Indeed, there appears to be no mention of cash balance plans in the legislative history. Rather, the purpose was to insure that employees who elect to work beyond normal retirement age will continue to accrue additional pension benefits for such service, subject to some significant exceptions. The precursor of Section 4(i)(1)(A) was introduced on the floor of the Senate in September 1986 as a proposed amendment to what became OBRA. The sponsors explained their objective was to require employers to continue to accrue pension benefits for employees who choose to remain employed past the age of 65. 132 Cong. Rec. 24903-05 (Sept.19, 1986).

A month later the Conference Committee opted to "generally follow the Senate amendments with certain modifications." H.R. Conf. Rep. No. 1012, 99th Cong., 2d Sess. 378. The Conference Report goes on to explain that

> Under the conference agreement, the rules preventing the reduction or cessation of benefit accruals on account of the attainment of age are not intended to apply in cases in which a plan satisfies the normal benefit accrual requirements for employees who have not attained normal retirement age. Under the benefit accrual rules, the rate of benefit accrual for an employee may vary depending on the number of years of service an employee may complete between date of hire and the attainment of normal retirement age. Id., at 379.

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have no claim for age discrimination under Paragraph (1). Paragraph (6) provides that a plan will not violate Paragraph (1) because the subsidized portion of an early retirement benefit is disregarded in determining benefit accruals.

In short, Congress was addressing the type of discrimination described at the very outset of this paper -- plan restrictions on further accruals after a participant reaches a specified age (65) -- not a theory of discrimination derived from the regulatory framework in which cash balance plans have been placed and the mathematical fact that the sum of compounded interest over a longer period is worth more than the sum of compounded interest over a shorter period. The focus in 1986 was on the cessation or reduction in benefit accruals after normal retirement, so that workers who choose to work beyond normal retirement age could continue to accrue additional benefits toward retirement. In contrast, the Sheppard thesis, by definition, relates only to benefit accruals before normal retirement, and presumes that everyone retires or stops accruing benefits at normal retirement age.

IV. The Authoritative Regulations Are Inconsistent With The Theory That Cash Balance Plans Are Inherently Unlawful Under ADEA

Paragraph (7) of ADEA Section 4(i) provides that

> (7) Any regulations prescribed by the Secretary of the Treasury pursuant to clause (v) of section 411 (b)(1)(H) of Title 26 and subparagraphs (C) and (D) of section 411(b)(2) of Title 26 shall apply with respect to the requirements of this subsection in the same manner and to the same extent as such regulations apply with respect to the requirements of such sections 411(b)(1)(H) and 411(b)(2).

Accordingly, Treasury pronouncements on the proper interpretation and application of the companion provisions in ERISA and in the Code to ADEA Section 4(i) are entitled to considerable weight.

On April 11, 1988, shortly after the effective date of subsection (i), the IRS issued proposed regulations that are inconsistent with Sheppard's disparate impact theory for holding cash balance plans in violation of the ADEA. Proposed Reg. § 1.411(b)-(2)(a) provided that a defined benefit plan does not come within the Paragraph (1) prohibition "solely because of a

positive correlation between increased age and a reduction or discontinuance in benefit accruals or account allocations under a plan." 53 F.R. 11876 (April 11, 1988). Also, Proposed Reg. § 1.411(b)-(2)(b)(2)(ii) explicitly sanctioned such "frontloaded" plan provisions in a final average pay plan as a 2 percent credit for the first 15 years of service and a credit of only 1 percent for each subsequent year of service.[10]

Later, in the preamble explaining its 1991 final regulations, which created a safe harbor from the restrictions on discrimination in favor of highly compensated employees for "frontloaded" cash balance plans, the IRS opined that

> The fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation [i.e., the pay credit] will not cause a cash balance plan to fail to satisfy the requirements of [Code] section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan. 56 F.R. 47528 (Sept. 19, 1991).[11]

Sheppard dismisses this statement as "obiter dicta" and as appearing to say "that the very thing that causes the age discrimination problem does not cause an age discrimination problem." But in reality it is Sheppard who is trying to find an age discrimination problem as a result of a governmental requirement (frontloading) that has nothing to do with age discrimination in the usual sense in which that concept has evolved under the ADEA. Further, Sheppard is trying to do this despite the IRS, as the author of the frontloading requirement on which Sheppard's theory rests, having stated it was not its intention to create an age discrimination issue when it created the frontloading safe harbor for cash balance plans.

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[10] Although the regulations were not final regulations, the Notice of Proposed Rulemaking provided that taxpayers may rely on the proposed regulations pending the issuance of final regulations. 53 F.R. 11878.

[11] Later, in IRS Notice 96-8, the Service indicated that it was proposing to approve only cash balance plans that were frontloaded, because it did not believe that backloaded interest credit plans could satisfy the accrual rules. 1996-1 C.B. 359.

In the case of cash balance plans, the more rapid buildup of accrued benefits in the early years of service is not age discrimination but rather a by-product of the regulatory dictate to "frontload" cash balance plans. Frontloading benefits all participants, regardless of age, who work for only a short period with any one employer. It is not age discrimination.

Aside from case law dealing directly with Section 4(i)(1)(A), there are some signposts in the existing case law dealing with the more general ADEA provisions that clearly point toward rejection of the Sheppard thesis.

For one thing, differences in treatment based on factors that are highly correlated with age, such as years of service and level of compensation, do not for that reason alone amount to age discrimination within the meaning of the ADEA. Five years after the IRS announced that reductions or cessations in benefit accruals based on factors other than age (but which correlate with age) do not violate the Code provision that mirrors ADEA Section 4(i)(1)(A), the Supreme Court reached the same conclusion with respect to the general prescriptions on age discrimination in the ADEA. Hazen Paper Co. v. Biggins, 507 U.S. 604 (1993). The plaintiff in that case was fired at age 62 when he was within weeks of completing 10 years of service and thus becoming vested under the defendant's pension plan. Because age and years of service are "analytically distinct," the employer's conduct, however reprehensible it might be, was not something that the ADEA was designed to prevent.

Earlier cases have held that a flat monthly supplement offered as an inducement to retire early does not amount to age discrimination merely because, in terms of actuarial equivalency, that supplement is "worth" more to younger employees (because of their longer life expectancies) than to older employees. Dorsch v. L.B. Foster Co., 782 F.2d 1421 (7th Cir. 1986).

V. The Case Law Provides No Support For The Notion That Cash Balance Plans Are Inherently Unlawful Under The ADEA

To date, no reported case has been found that upheld an ADEA claim incorporating the Sheppard thesis. Indeed, only one case applying ADEA Section 4(i)(1)(A) is of even passing interest. Indeed, only one case applying that provision is of even passing interest. In Atkins v. Northwest Airlines, Inc., 967 F.2d 1197 (8th Cir. 1992), several current and retired pilots, all of whom worked as flight engineers after reaching the normal retirement age for pilots of age 60, alleged a violation of Section 4(i)(1)(A), claiming that the rate of accrual for pilots age 55 to age 60 was higher than the rate of accrual for those who worked past age 60, because the benefit reduction factor for early retirement (0.25 percent for each month under the age of 60) meant that, as a practical matter, benefits accrue at a higher rate from age 55 to 60 than after age 60. As the court saw it, the plaintiffs were arguing for a "late retirement bonus" of 0.25 percent for each month after age 60 in order to bring the post-60 rate of accrual up to the rate of accrual from age 55 to age 60. Reasoning that early retirement discounts are not part of "accrued benefits," the court affirmed summary judgment for Northwest. 967 F.2d at 1200-01. In passing, the court noted that plaintiffs might have "a valid argument for the bargaining table," but not under ERISA or ADEA. Id. at 1200. Although many pilots who worked past age 60 would not enjoy any increase in the pensions they could have received if they retired at age 60, while pilots age 55-60 would be earning greater pensions,[12] that outcome did not

> result from age discrimination. It merely reflects that the early retirement discount is exhausted. Id. at 1201.

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[12] This outcome was probable because the Northwest plan "capped" the years of service used in calculating the benefit, and final average pay was not likely to increase because, pursuant to requirements of the Federal Aviation Administration, pilots had to step down to flight engineer positions at age 60, which meant lower salaries.

Similarly, a compensation policy that awards larger annual salary increases to employees with the lowest current salaries (and who as a group are nearly always younger than the highest paid employees holding the same job) is not unlawful age discrimination because its purpose is to create pay equity. E.g., Davidson v. Bd. of Governors of State Colleges & Univs. for Western Ill. Univ., 920 F.2d 441 (7th Cir. 1990); Tagatz v. Marquette Univ., 861 F.2d 1040 (7th Cir. 1988). As has been seen, the Sheppard thesis is at bottom based on the disparate impact analysis.[13] Whether the disparate impact analysis is viable under the ADEA is quite problematic. Biggins at the least suggests that the disparate impact theory is not available to ADEA plaintiffs. Following Biggins, three circuit courts have squarely rejected the notion that disparate impact claims may be asserted under the ADEA.[14] In three other circuits, in dicta or in concurring opinions, the courts of appeals have expressed doubt that the disparate impact analysis survives after Biggins.[15]

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[13] The disparate treatment and disparate impact analyses are two different ways of linking the unfavorable treatment (lower pay, failure to hire, lesser pension accruals) with the protected class or characteristic, which in this case is age. The first looks to the actor's (employer's) intent; the second looks only to consequences. Since both Section 4(i)(1)(A) and the general prohibition on age discrimination require linkage between age and the unfavorable treatment, both surely require either a disparate treatment or a disparate impact analysis, and the case law dealing generally with the propriety of using the disparate treatment analysis in the ADEA context should also be applicable to Section 4(i)(1)(A) claims.

[14] See Mullin v. Raytheon Co., 164 F.3d 696, 699-704 (1st Cir.), pet. for cert. filed No. 98-1779, 67 U.S.L. Week (May 5, 1999) (discussing in depth the legislative history and case law on the issue of disparate impact and the ADEA and holding that "the ADEA does not impose liability under a theory of disparate impact."); Salvato v. Illinois Dep't of Human Rights, 155 F.3d 922, 926 (7th Cir. 1998) (noting that "[I]n this circuit, at least, the ADEA does not permit liability based solely on disparate impact."); Ellis v. United Airlines, Inc., 73 F.3d 999, 1009 (10th Cir. 1996) (holding that "plaintiffs cannot bring a disparate impact claim under the ADEA").

[15] See Gantt v. Wilson Sporting Goods Co., 143 F.3d 1042, 1048 (6th Cir. 1998) (dicta); Rhodes v. Guiberson Oil Tools, 75 F.3d 989, 1004 (5th Cir. 1996) (en banc) (DeMoss, J., concurring in part and dissenting in part, in which Judges Smith and Barksdale joined) (concurring opinion); DiBiase v. SmithKline Beecham Corp., 48 F.3d 719, 734 (3d Cir. 1995) (doubted the viability of the disparate impact theory in light of the Hazen Paper decision, writing that "Congress recognized that neutral policies not motivated by discriminatory intent may be permissible employment practices"; Turlington v. Atlanta Gas Light Co., 135 F.3d 1428, 1436-37 n.17 (11th Cir.), cert. denied, 119 S. Ct. 405 (1998) (reserving for later decision whether the ADEA permits disparate impact claims).

In three of the circuits in which no controlling court of appeals decision has been found, there are district court decisions holding that disparate impact claims cannot be asserted under the ADEA.[16]

Only in the Eighth and Ninth Circuits, and in the Second Circuit with a significant qualification, is there case law indicating that ADEA disparate impact claims will be entertained.[17] Even in these circuits, the mere availability of the theory does not mean that the plaintiff attacking cash balance plans will necessarily prevail.

VI. Conversions Of Final Average Pay Plans To Cash Balance Plans Are Not Inherently Violative Of The ADEA

Most of the controversy and the allegations of ADEA violations occur in the context of conversions of existing final average pay plans to cash balance plans. Two issues unique to the context of a conversion, are discussed here. First, long service employees, particularly those who are not offered a choice of the better of the two plans,[18] contend in some cases that they had assurances that lead them to expect at normal retirement age a much larger benefit under the final average pay plan than they now expect to receive as a result of the conversion. Second, another common complaint is that, due to the way in which the conversion was designed, some employees will experience no growth in their accrued benefits for some

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[16] See Fobian v. Storage Tech. Corp., 959 F. Supp. 742, 746 (E.D. Va. 1997); Davidson v. Quorum Health Group, Inc., 1 F. Supp. 2d 1321, 1326 (N.D. Ala. 1997); Evans v. Atwood, 38 F. Supp. 2d 25, 30 (D.D.C. 1999).

[17] Smith v. City of Des Moines, Iowa, 99 F.3d 1466, 1470 (8th Cir. 1996); E.E.O.C. v. Local 350, Plumbers and Pipefitters, 998 F.2d 641, 646, 648 n.2 (9th Cir. 1993); Criley v. Delta Air Lines, Inc., 119 F.3d 102, 105 (2d Cir. 1997), cert. denied, 118 S. Ct. 626 (1997) (plaintiffs can succeed on disparate impact theory only if they show "a disparate impact on the entire protected group, i.e., all workers aged 40 and over").

[18] In some cases, the most senior employees are offered the option of staying with the old plan or are assured that they will receive the better of the benefits calculated under the new and old plans. But there can be some who are too young or have too little service to qualify for such treatment, but who would be better off if the old plan remained in effect and the employees continued working to normal retirement age.

years following the conversion (this is the so-called "wear away" problem), while others with relatively few years of service (and generally younger persons) experience a growth in their retirement benefits immediately upon conversion.

The first of these claims are really claims for breach of contract rather than age discrimination. Whether such claims for breach of contract have merit will very much depend on the particular facts of each case.[19] But the question whether employees may or may not have a legitimate contract claim is quite different from the contention that their rights under the ADEA have been violated. The ADEA does not protect contract rights or insulate older employees from such adverse personal actions as the cutback or elimination of certain benefits (health insurance, for example), the imposition of restrictions on salary increases, and other measures that may disproportionately disadvantage older workers because the measures take into account factors such as high pay that correlate with age. E.g., Davidson v. Bd. of Governors of State Colleges & Univs. for Western Ill. Univ., supra; Tagatz v. Marquette Univ., supra; Wooden v. Board of Educ. of Jefferson County, Ky, 931 F.2d 376, 380 (6th Cir. 1991); MacPherson v. University of Montevallo, 922 F.2d 766, 773, 775-76 (11th Cir. 1991); Britt v. Grocers Supply Co., 760 F. Supp. 606 (S.D. Tex. 1991).

As for the "wear away" issue, that phenomenon is attributable more to the years of service than to the age of the affected employees. An older individual with few years of service because she is a mid-career hire is not likely to have a wear away problem even though a

[19] An employer that gave employees unqualified assurances that their retirement benefits would reach some specified level at normal retirement age may indeed be liable in contract to those employees. On the other hand, an employer that has taken care to point out that retirement plans may be amended or terminated at any time and that the only benefits that are protected are those which have accrued, has not created a level of expectations that are likely to be treated as amounting to an enforceable contract.

younger colleague with many more years of service may be subject to a "wear away" period. As noted above, age and service are "analytically distinct." Hazen Paper Co. v. Biggins, supra. Further, the fact that one person with a relatively large vested benefit is not increasing that benefit still further while another employee with only a small vested benefit is receiving additional accruals appears to be no different for ADEA purposes from the situation in which the generally older workers at the top of the pay scale for a particular job are receiving little or no salary increases while others in that job with smaller salaries are "catching up" to their peers.

CONCLUSION

Had Congress and the IRS encouraged or required backloading of cash balance plans, the contention that those plans invariably violate the ADEA would never arise. Did the IRS intend in creating the frontloaded safe harbor for cash balance plans to insure that those plans would for that reason be illegal under the ADEA? The IRS quite explicitly stated it had no such intention when it stated that cash balance plans would not violate the restrictions on age-related discrimination in the Code merely because of frontloading. In short, the Sheppard theory that would condemn under the ADEA every cash balance plans has no merit.

by:
Michael S. Horne, Esq.
COVINGTON & BURLING

MCB ADEA-ISSUE H MEM-TXT-ES-FIN

www.lpa.org

June 5, 2000

VIA HAND DELIVERY

The Honorable Charles Grassley
Chairman, Senate Special Committee on Aging
United States Senate
Dirksen Building, Room SD-G31
1st and C Street, N.E.
Washington, D.C. 20510

Re: **The Cash Balance Conundrum: How to Promote Pensions Without Harming Participants**

Dear Chairman Grassley:

We wish to thank your committee for holding a hearing on cash balance pension plans. We hope that this hearing will address the advantages to both employers and employees of these plans. The emergence of cash balance pension plans reflects a significant advance in providing retirement security for workers in a dynamic, modern workplace. We are concerned that attempts to protect employees from change will impair employers' ability to adapt to changing business conditions, ultimately putting both employers and employees at economic risk. We respectfully request that this committee address these concerns.

LPA is a public policy advocacy organization representing corporate executives interested in human resource policy from more than 200 leading corporations doing business in the United States. LPA's purpose is to provide in-depth information, analysis, and opinion of current situations and emerging trends in labor and employment policy. LPA members are typically companies with business operations in the United States that have more than $750 million in revenues and more than 2,500 employees. The total number of persons employed by LPA member companies in the United States is nearly 13 million Americans-more than 12 percent of the private sector workforce.

A number of companies have converted traditional defined benefit plans to cash balance pension plans and have received favorable determination of qualification letters from the Internal Revenue Service ("IRS"). In addition, numerous LPA member companies, which face a dynamic business environment, may be contemplating converting existing defined benefit pension plans to cash balance pension plans. Consequently, LPA member companies have a strong interest in any regulatory and/or legislative consideration of cash balance pension plan conversions.

The recent scrutiny concerning conversions to cash balance pension plans stems from some commentators' mistaken belief that it is a violation of the Age Discrimination in Employment Act ("ADEA") for employers to convert from a traditional defined benefit plan to a cash balance pension plan, because longer tenured employees may see their expectation of retirement benefits reduced when such a conversion is made. LPA believes that these commentators misinterpret the relevant law.

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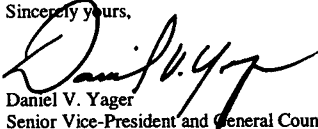
Attached for inclusion in the record of this committee's hearing, along with this correspondence, is a copy of the comments that LPA submitted to the IRS on January 19, 2000 pursuant to its solicitation for comments concerning cash balance pension plan conversions. ("Defined Benefit Plans: Solicitation for Comments," 64 Fed. Reg. 56578 (1999)). LPA's analysis, contained in its comments to the IRS, concludes that the conversion of a traditional defined benefit plan to a cash balance pension plan does not violate the prohibitions against age discrimination contained in the Internal Revenue Code, the ADEA, and the Employees Retirement Income Security Act ("ERISA").

In analyzing the effects of a cash balance pension plan conversion on employees covered by the plan, it is important to keep in mind that nothing in ERISA requires an employer to adopt or maintain a defined benefit plan, nor does the law prescribe any specific accrual formula or any specific level of benefits to be provided. Thus, an employer's decision to convert from a traditional defined benefit pension plan to a cash balance pension plan may be viewed as an alternative to a lawful termination of the plan. Attempts to restrict the ability of employers to meet the evolving demands of the workplace ultimately risk the abandonment of pension plans altogether, since employers will otherwise feel locked into approaches that no longer bear any relevance to the needs of their employees.

The issue of cash balance pension plans and plan conversions calls for thoughtful analysis, not unthinking reaction, stretching of current laws to fit a purpose for which they were clearly not intended, or enactment of new laws which would serve to stop the creation of benefit plans that meet American workers' increasing need for portability of retirement benefits.

We thank you for the opportunity to submit these comments for your consideration. LPA stands ready to work with you. If you or your staff would like to discuss these matters further, please do not hesitate to contact us.

Sincerely yours,



Daniel V. Yager
Senior Vice-President and General Counsel

Enclosures (including electronic format)

cc:
Honorable Jim Jeffords
Honorable Larry Craig
Honorable Conrad Burns
Honorable Richard Shelby
Honorable Rick Santorum
Honorable Chuck Hagel
Honorable Susan Collins
Honorable Michael Enzi
Honorable Jim Bunning
Honorable Tim Hutchinson
Honorable John Breaux
Honorable Harry Reid
Honorable Herbert Kohl
Honorable Russ Feingold
Honorable Ron Wyden
Honorable Jack Reed
Honorable Evan Bayh
Honorable Blanche Lincoln
Honorable Richard Bryan

www.lpa.org

January 18, 2000

VIA HAND DELIVERY

Internal Revenue Service
Attn: CC:DOM:CORP:R (Cash Balance Pension Plans and Conversions)
Room 5226
1111 Constitution Avenue, N.W.
Washington, D.C. 200224

Re: **Cash Balance Pension Plan Conversions Do Not Violate Prohibitions Against Age Discrimination**

To Whom It May Concern:

Thank you for inviting the public to present comments concerning cash balance pension plan conversions. LPA, Inc. ("LPA") is pleased to provide the following analysis concluding that the conversion of a traditional "defined benefit plan" to a cash balance pension plans does not violate the prohibitions against age discrimination contained in the Internal Revenue Code, the Age Discrimination in Employment Act ("ADEA"), and the Employees Retirement Security Act ("ERISA").

LPA is a public policy association of senior human resource executives, representing more than 250 major corporations doing business in the United States. LPA's purpose is to provide in-depth information, analysis, and opinion of current situations and emerging trends in labor and employment policy among its member companies, policy makers, and the general public. LPA members are companies with business operations in the United States that have more than $750 million in revenues and more than 2,500 employees. The total number of persons employed by LPA member companies in the United States is nearly 13 million Americans – more than 12 percent of the private sector workforce.

A number of companies have converted traditional defined benefit pension plans to cash balance pension plans and have received favorable determination of qualification letters from the Internal Revenue Service ("IRS"). In addition, for important reasons discussed in more detail herein, numerous LPA member companies may be contemplating converting existing defined benefit pension plans to cash balance pension plans. Consequently, LPA member companies have a strong interest in the IRS's interpretation of the prohibitions against age discrimination contained in the Internal Revenue Code,[1] the ADEA,[2] and ERISA[3] and their application to cash balance pension plans conversions.

Overview of Cash Balance Pension Plans

Greater workforce mobility, combined with a trend toward more flexibility in pensions have led many companies to adopt a type of pension plan that originally emerged in the 1980's – cash balance pension plans. Cash balance pension plans – somewhat similar to traditional 401(k) plans – afford employees the opportunity to contribute annually to their account and then take those accounts with them if they switch companies. Cash balance pension plans are designed to include the characteristics of both defined benefit (DB) and defined contribution (DC) plans. The DB part of a cash balance pension plans pays a benefit based on a predetermined formula, in this case, average pay over the employee's tenure with a company. Moreover, as with DB plans,

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the company – not the employee – determines where the money should be invested. Thus, employers also bear the investment risk under cash balance pension plans.

The DC part of a cash balance pension plan is a record-keeping mechanism that creates an individual account for each participant that accumulates assets over time. These are hypothetical accounts only. Under cash balance pension plans, employer contributions are based on an annual benefit credit that is usually expressed as a percentage of pay plus an annual interest credit. These annual credits are stated as if they were part of each participant's individual account balance.

Although cash balance pension plans have characteristics of both DB and DC plans, they are really DB plans and are funded on actuarial tables. As such, they are eligible to become tax qualified under ERISA. However, in traditional DB plans, the pension benefit is computed from a formula that is based in large part on years of service and pay during the final years before retirement. Hence their popularity with employees that spend all or much of their career with one employer. While in cash balance pension plans, benefit accumulations occur much more evenly over an employee's career than they would in a traditional benefit plan.

The amended benefit accrual formulas of cash balance pension plans typically equalize accruals over the course of an employee's entire career. Under a cash balance pension plan accrual formula, each employee, regardless of age, receives a pension credit based on a percentage of his or her salary, plus interest. The accrual and interest rates usually are the same for all employees – except that some plans use higher accrual rates for older workers (a practice that is clearly permitted by the ADEA).

In analyzing the effects of a cash balance pension plan conversion on employees covered by the plan, it is important to keep in mind that nothing in ERISA requires an employer to adopt or maintain a defined benefit plan, nor does the law prescribe any specific accrual formula or any specific level of benefits to be provided. Consequently, although employees have a right to any vested benefits they already have accrued under a defined benefit plan, they have no legal right to expect that the plan will remain in effect in the future or that, if it does, its accrual formula will remain unchanged – any more than an employer has a right to expect that all of its employees will continue working for it until retirement. Thus, an employer's decision to convert a traditional defined benefit pension plan to a cash balance pension plans may be viewed as an alternative to a lawful termination of the plan.

Cash Balance Pension Plans Appeal to Employers and Employees

In the past few years more and more companies have switched from traditional DB plans to cash balance pension plans. A recent estimate indicated that approximately 22 of the Fortune 100 have adopted cash balance pension plans and that these types of plans cover eight to nine million workers.[4] Proponents of cash balance pension plans tout a primary benefit – these large plans offer larger benefit accruals early in an employee's career. Many employers firmly believe that faster accruals and portability lure job candidates to their recruitment tables. The cash balance model has appealed to employers and employees for a variety of other reasons, including:

- Traditional DB plans often have low return on investment in employee satisfaction. This is particularly important in today's competitive labor market. In fact, few workers understand their DB plans since pension benefits

are stated in the form of an annuity payable at retirement rather than the more familiar account balance format;

- The cash balance concept is easier to communicate. As with 401(k) or other DC plans, participants in cash balance pension plans see the growth of their account balances;
- The portability of cash balance pension plans appeals to today's on-the-move workforce. Cash balance pension plans provide a steady build-up of benefits over time, creating a larger balance for employees who terminate at mid-career. Once vested in a cash balance pension plans, if they leave their employment as most do today, they walk with their full retirement benefit. In addition, lump-sum cash balance payments can be rolled into an IRA or other qualified plan;
- The cash balance concept complements the performance-over-tenure approach many employers are eager to promote; and
- Cash balance pension plans are useful in mergers and acquisitions. Some employers are using cash balance pension plans to merge disparate retirement programs. The cash balance model allows different business units to adjust credit levels based on their particular economic and recruiting environment.

The Supreme Court's Decision in *Hazen Paper* Clearly Establishes That Employment Decisions Must Be Based on Age, Not Merely Correlated With Age, To Violate the Age Discrimination Prohibitions

It has been contended that it is a violation of the ADEA for employers to convert from a traditional DB plan to a cash balance pension plan, because longer tenured employees may see their expectation of retirement benefits reduced when such a conversion is made. Some have suggested that the ADEA is a tool that may be used to challenge conversions from traditional DB plans to cash balance pension plans. LPA believes that these commentators misinterpret the law.

Admittedly, the issue is a complex one. It involves the interaction between the ADEA, the Internal Revenue Code, ERISA, and the burdens of proof in discrimination cases. The issue has become so politicized that Congress, the IRS, the EEOC, and the Department of Labor have all weighed in on the matter.

Thus, in order to combat inaccurate and negative stereotypes about older workers, Congress enacted the ADEA and prohibited employers from making decisions based solely on age for persons aged 40 or older. The ADEA removes age as a deciding factor for persons 40 or older in the terms and conditions of employment, including hiring, firing, demotions, assignments, promotions, and benefits. Although employers simply cannot use age as an employment criterion with regard to people aged 40 or older, employers remain otherwise free to make business decisions as they see fit. The ADEA does not require that employers prefer older employees to younger ones or that older employees receive favorable treatment. It only serves to level the playing field, at least on the basis of age, for all employees.

The courts, which have confronted ADEA claims, have rejected attempts to turn the ADEA into a mandate that imposes preferential treatment for older workers. The U.S. Supreme Court held in *Hazen Paper Co. v. Biggins*, 507 U.S. 604 (1993), that Congress in enacting the ADEA

intended to prevent discrimination based on inaccurate and damaging stereotypes, but the ADEA does not address the incidental discriminatory effects arising from facially age-neutral policies; therefore these are not redressable.

In *Hazen Paper*, the Supreme Court explained:

> When the employer's decision is wholly motivated by factors other than age, the problem of inaccurate and stigmatizing stereotypes disappears. This is true even if the motivating factor is correlated with age .... Because age and years of service are analytically distinct, an employer can take account of one while ignoring the other, and thus it is incorrect to say that a decision based on years of service is necessarily "age based."[5]

In other words, the ADEA targets discrimination against employees who fall within a protected age category, not employees who have attained a given seniority status.[6] Thus, a complainant who wants the protection of the ADEA must generally show that the employer would not have treated him or her adversely "but for" his or her age. While age need not be the sole motivating factor for the employer's decision, age must be the determining factor in the employer's decision. That is, employers may make employment decisions, including decisions about what benefits to offer, without the ADEA being implicated as long as the reason behind the decision is not age.[7] Thus, employers can base their business decisions on factors such as cost savings or years of service without worrying that the ADEA has been violated. In sum, as long as an employer has a business justification for its decision, and that justification is not age, the ADEA is not violated.

The Effects of Cash Balance Pension Plans on IRS Requirements Regarding "Backloading"/"Frontloading"/ Do Not Violate the Age Discrimination Prohibitions

Some commentators have suggested that cash balance pension plans violate the prohibitions against "backloading"[8] and "frontloading"[9] accrual rules under § 204(b) of ERISA. Although it may be true that cash balance pension plans do not fit neatly within the rules of this section of ERISA, this is because these rules were designed with traditional "career average pay" and "final average pay" formulas in mind. In contrast, in a cash balance formula if interest is credited each year as earned, the interest credit rises yearly as the account balance increases from prior accruals. Some have argued that over time this may violate the backloading rules of § 204(b)(1)(A)-(C) of ERISA because it may cause the rate of accrual to be more than 133 1/3% of any prior year's rate.

On the other hand, if the cash balance pension plans is frontloaded, some argue that the rate of accrual appears to decrease in violation of the age discrimination provisions of § 204(b)(1)(H)(I) of ERISA that prohibit reduction in the rate of accruals "because of the attainment of any age." The IRS can ultimately disqualify a plan if it violates the backloading/frontloading rules or the rules against age discrimination.

However, fortunately, the IRS has already provided a requirement for cash balance pension plans to resolve the backloading/frontloading dilemma. To resolve the dilemma, the IRS requires a plan to be frontloaded. If the plan is frontloaded, then the IRS deems that the decrease in rate of accrual caused by this frontloading is not on account of age. The IRS has promulgated this guidance in three separate publications.

In IRS Notice 96-8, which was released January 18, 1996, the IRS suggested that it would approve cash balance pension plans only if they are frontloaded. The notice stated that it did not believe backloaded interest credit plans could satisfy any of the accrual rules and also opined that "benefits attributable to interest credits are in the nature of accrued benefits . . . and thus, once accrued, must become non-forfeitable."

In the Preamble to the September 19, 1991 final regulations on "Nondiscrimination Requirements for Qualified Plans,"[10] the IRS specifically provides that frontloading of a cash balance pension plan does not violate the prohibitions against reductions in the rate of accrual based on age:

> Among other requirements, the interest adjustments through normal retirement age must be accrued under the plan in the year the hypothetical allocation in which they relate is accrued . . . . The fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance pension plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan.

The IRS's previous guidance related to age discrimination and rates of accrual provide a reasonable basis for this statement.

In temporary regulations issued on April 11, 1988 addressing these issues, the IRS noted that a defined benefit plan does not cease or reduce the rate of accrual on the basis of age "solely because of a positive correlation between increased age and a reduction or discontinuance in benefit accruals or account allocations under a plan."[11] In addition, the IRS stated that plans can provide for benefit accrual reductions that will closely correlate to age (and that in fact must decrease for each participant as he gets older) (e.g., provide for 3% credit for first 10 years of service and 2% thereafter).[12]

In sum, the IRS has already provided guidance to employers that positive correlation between age and the rate of accrual is not, in itself, discrimination on the basis of age. This is consistent with the ADEA, which states that acting based on "reasonable factors other than age" – even if those factors strongly correlate with age such as seniority, years of service, or salary – is not age discrimination.[13] Thus, the fact that the rate of accrual decreased because of the compounding of interest is not the same thing as decreasing because of age.[14] The IRS requirement is a "factor other than age." As such, it cannot be the basis for a finding of unlawful age discrimination under the ADEA.

Some critics have also argued that a plan's use of the same benefit accrual rate for all employees inherently discriminates against older workers, because an amount of money credited to the pension account of a younger employee will be worth substantially more by the time that the employee reaches normal retirement age than the same amount credited to the account of an older employee will be worth when the older employee reaches normal retirement age. However, if one subscribes to this theory, of course, then 401(k) plans also would have to be considered inherently discriminatory, an obviously flawed conclusion that no one is advocating. Therefore, it is clear that in neither instance is the difference in values of the two employees' pension plan benefits the result of age discrimination. Rather, it is simply the natural consequence of the compounding of interest over differing periods of time, not intentional age discrimination.

"Wearaway" Following a Conversion to a Cash Balance Pension Plan Does Not Violate the Age Discrimination Prohibitions

"Wearways" are one of the most controversial policy issues in cash balance pension plans. The term "wearaways" relates to situations in which for a period of time following a plan conversion, there is a difference between the hypothetical balance in an employee's cash balance account and the amount of the benefit to which the employee actually is entitled. Because § 204(g) of ERISA prohibits any "cutback" in that accrued benefit, the plan must offer the accrued benefit from the old plan as long as it is greater than the hypothetical account balance. The result is that an employee will fail to accrue an increase in benefits until his or her hypothetical account balance and subsequent accruals exceeds his former accrued benefit – i.e., the difference wears away.

However, "wear away" thus is something of a misnomer. No part of any employee's accrued benefit is ever reduced or taken away. Some employees simply may have to wait for a period of time before they become entitled to more under the new plan formula than the benefit they already had accrued at the time of conversion. In no respect does this phenomenon involve any action taken by the employer *because of* age, nor does it have disparate impact *because of* age. Rather, any difference in the amount of "wear away" that any two given employees might experience following a plan conversion is strictly a function of nonage factors, which may or may not include differences in salaries, years of service, actuarial assumptions, and interest rates, coupled with the effect of the anti-cutback rule.

Indeed, it quite possible that a younger employee who has a substantial number of years of service (and therefore a substantial vested pension benefit) may be subject to so-called "wear away" following a cash balance conversion, while an older employee with only a few years of service (and therefore only a small vested benefit) might not be subject to this phenomenon at all. Again, any such difference occurs because of factors that are *analytically distinct* from age and, therefore, fall outside the purview of the Internal Revenue Code, the ADEA, and ERISA.

The ADEA Does Not Permit a Cause of Action Based on the Disparate Impact Theory of Discrimination

As a threshold matter, LPA strongly agrees with the United States courts of appeals that have concluded that a valid disparate impact claim cannot be brought under the ADEA.[15] The most compelling argument supporting these court decisions is grounded in the text of the ADEA itself. The statute contains an important provision that specifically authorizes employers to differentiate in their treatment of employees "based on reasonable factors other than age."[16] Although the Supreme Court has not decided expressly whether disparate impact claims are actionable under the ADEA, in *County of Washington v. Gunther*, 452 U.S. 161 (1981), the Court interpreted a similar provision of the Equal Pay Act ("EPA"),[17] which permits employers to differentiate in pay rates for men and women based on any "factor other than sex." The Court concluded that this language precludes disparate impact claims under the EPA.[18] Inasmuch as the pertinent language of § 623(f)(1) is virtually identical to that of § 623(d), the logic of *Gunther* compels the conclusion that disparate impact claims are not cognizable under the ADEA either.[19]

Federal courts have found additional support for this conclusion in the ADEA's legislative history and underlying policy – both of which indicate that the ADEA was not meant to include disparate impact-type claims. As Justice O'Connor noted in her opinion for the Court in *Hazen*

Paper, the ADEA was passed because of Congress' "concern that older workers were being deprived of employment on the basis of inaccurate and stigmatizing stereotypes" about age.[20]

After contrasting the disparate treatment and disparate impact theories and reciting the elements of a disparate treatment claim, Justice O'Connor declared that "[d]isparate *treatment*, thus defined, captures the essence of what Congress sought to prohibit in the ADEA."[21] Thus, although the Supreme Court did not expressly decide the issue in *Hazen Paper*, its opinion clearly indicates that *disparate* impact is *not* what Congress had in mind in enacting the ADEA.

Additional support for this position, can be found in the fact that, when it enacted the Civil Rights act of 1991, Congress amended the ADEA in several respects but limited the provisions codifying the disparate impact theory of discrimination to Title VII. Thus, 42 U.S.C. § 2000e-2(k) addresses the burden of proof in respect to practices that cause disparate impact on the basis of race, color, religion, sex, or national origin but has no application to claims of disparate impact on the basis of age. Thus, this provides additional evidence that Congress never envisioned the ADEA as covering disparate impact claims. For all these reasons, LPA contends that the disparate impact theory is not viable under the ADEA and, therefore, cannot be used as a basis for claiming that cash balance conversions unlawfully discriminate against older workers.

Cash Balance Pension Plan Conversions Do Not Cause Disparate Impact

LPA believes that the majority of courts, which have ruled on the issue, have correctly determined that the ADEA does not permit disparate impact claims. However, even in those circuits that have permitted disparate impact claims, this theory does not provide a viable basis for attacking conversions to cash balance pension plans.

To make a *prima facie* showing of disparate impact, a plaintiff must identify a particular employment-related practice that, although facially neutral, causes a disparate impact on a protected class of employees because of their protected characteristic.[22] A *prima facie* disparate impact case, therefore, has a connection to the protected characteristic.[23] Neither a cash balance plan itself nor an employer's action in converting to such a plan presents all three of these essential elements of disparate impact with respect to age.

Although cash balance pension plans and plan conversions are facially age neutral, they lack the necessary elements of disparateness and causation. With regard to disparateness, they do not produce dichotomous results as between the protected and unprotected classes under the ADEA. Rather, they produce a myriad of different effects on different members of both groups. The continuous spectrum of age – and the infinite number of potential subgroups that results – makes the impact-on-subgroups theory inherently unworkable. A conversion to a cash balance pension plan will have different effects on employees in different age groupings, both within and outside the overall class of workers aged 40 or over.

Moreover, its effects on those in any given age grouping will be changing continuously as the composition of the group changes with time. Consequently, there may be an infinite and varying number of subgroups claiming to be suffering adverse effects in differing degrees, while some members of the statutorily protected group are not adversely affected at all by a conversion to a cash balance pension plan. In such circumstances, the element of disparateness on an overall protected class is impossible to establish.

Nor is it possible to establish a causal connection between any effects a cash balance pension plans or plan conversion may have on any group or subgroup or workers and the ages of those

workers. For again, any such effects of the plan or plan conversion result not from age itself but from other factors which may or may not be correlated with age. These causative factors typically include years of service and salary level – factors which, although they may correlate with age, have been specifically recognized by the Supreme Court as being "analytically distinct" from age itself.[24] Thus, a causal connection to years of service or salary is not a causal connection to age.

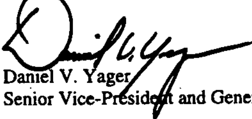
As previously stated, to establish unlawful disparate impact, complainants must show that they were adversely affected "*because of* their membership in a protected group."[25] Moreover, *Hazen Paper* makes clear that the existence of a correlation between years of service and age does not mean that "a decision based on years of service is necessarily 'age-based.'"[26] In sum, although *Hazen Paper* does not expressly decide the issue of whether disparate impact claims are ever cognizable under the ADEA, the Court's reasoning in that case plainly forecloses any argument that the ADEA prohibits employment practices that have disparate impact because of nonage factors that happen to correlate with age.

Conclusion

The issue of the legality of cash balance pension plans and plan conversions calls for thoughtful analysis, not unthinking reaction and stretching the ADEA, or any other law, to fit a purpose to which it was clearly not intended. This is particularly the case where the purpose would be to stop the creation of benefit plans that meet American workers' increasing need for portability of retirement benefits. One fact must be kept in mind. Employers are not required to have pension plans. Thus, attempts to restrict the ability of employers to meet the evolving demands of the workforce ultimately risk the abandonment of pension plans altogether, since employers will otherwise feel locked into approaches that no longer bear any relevance to the needs of their employees.

For the foregoing reasons, LPA respectfully urges the IRS to recognize that cash balance pension plans and plan conversions do not violate the Internal Revenue Code, the ADEA, or ERISA. We thank the IRS for the opportunity to submit these comments.

Sincerely yours,



Daniel V. Yager
Senior Vice-President and General Counsel

Endnotes

[1] Section 411 (b)(1)(H)(i) of the Internal Revenue Code states:

> In general. Notwithstanding the preceding paragraphs, a defined benefit plan shall be treated as not satisfying the requirement of this paragraph if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age.

26 U.S.C. § 411 (b)(1)(H)(i).

[2] Section 623 (i)(1) of the ADEA states:

> Except as otherwise provided in this subsection, it shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit plan which requires or permits –
> (A) in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age, or
> (B) in the case of a defined contribution plan, the cessation of allocations to an employee's account, or the reduction of the rate at which amounts are allocated to an employee's account, because of age.

29 U.S.C. § 623 (i)(1).

[3] Section 204 (b)(1)(H) of ERISA states:

> Notwithstanding the preceding subparagraphs, a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age.

29 U.S.C. § 1054 (b)(1)(H).

[4] Albert B. Crenshaw, "Companies Embrace New Pension Plan," *Washington Post*, Financial (January 31, 1999).

[5] *Hazen Paper*, 507 U.S. at 611.

[6] *See, e.g., Snow v. Ridgeview Medical Center*, 128 F.3d 1201 (8th Cir. 1997); *Bialas v. Greyhound Lines, Inc.*, 59 F.3d 759 (8th Cir. 1995); *Lyon v. Ohio Education Association*, 53 F.3d 135 (6th Cir. 1995); *Thomure v. Phillips Furniture Co.*, 30 F.3d 1020 (8th Cir. 1994); *Gray v. York Newspapers, Inc.*, 957 1070 (3rd Cir. 1992).

[7] *See Goldman v. First National Bank of Boston*, 985 F.2d 1113 (1st Cir. 1993) (no inference of age bias could be drawn from employer's conversion to cash balance pension plan).

[8] Backloading occurs when a disproportionate percentage of benefits are earned late in the employee's working career.

[9] Frontloading occurs when the pension plan credits the future compounding of the interest credit in the year in which the interest credit is earned.

[10] 56 FR 47524 (September 19, 1991).

[11] IRS Temp. Reg. at § 1.411(b)-(2), 53 FR 11876 (April 11, 1988).

[12] IRS Temp. Reg. at § 1.411(b)-(2)(a). The temporary regulation does also provide, however, that any reduction in the rate of benefit accrual "may not be based, directly or indirectly, on the attainment of any age." § 1.411(b)-(2)(b)(3)(ii), and that "whether a limitation is indirectly based on age is determined with reference to all the facts and circumstances." § 1.411(b)-(2)(b)(2)(ii).

[13] 29 U.S.C. § 623(f)(1). *See also Hazen Paper Co. v. Biggins*, 507 U.S. 604 (1993).

[14] Apparently, despite the IRS's guidance, some IRS officials think that the issue should be reexamined. For example, the IRS has sided with the plaintiffs in two of the cash balance pension plan cases currently in litigation, *Eaton v. Onan Corporation* and *Lyons v. Georgia Pacific*. It is LPA's belief that the IRS is mistaken in its position in these cases and that it should maintain its longstanding policy that conversions to cash balance pension plans do not violate the Internal Revenue Code, the ADEA, or ERISA.

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[15] *See Mullin v. Raytheon Co.*, 164 F.3d 696, 702 (1st Cir. 1999), *cert. denied*, ___ U.S. ___, 120 S. Ct. 44, 145 L. Ed. 2d 40 (1999); *Ellis v. United Airlines, Inc.*, 73 F.3d 999, 1008 & n.14 (10th Cir. 1996), *cert. denied*, 517 U.S. 1245 (1996); *Francis W. Parker School*, 41 F.3d 1073, 1076-1077 (7th Cir. 1994), *cert. denied*, 515 U.S. 1142 (1995). *See also DiBiase v. SmithKline Beecham Corp.*, 48 F.3d 719, 732-734 (3rd Cir. 1995), *cert. denied*, 516 U.S. 916 (1995) (expressing court's view that it is "doubtful" that disparate impact theory is viable under the ADEA).
[16] 29 U.S.C. § 623(f)(1).
[17] 29 U.S.C. § 626(d).
[18] *Gunther*, 452 U.S. at 170-171.
[19] *See Francis W. Parker School*, 41 F.3d at 1077.
[20] *Hazen Paper*, 507 U.S. at 610.
[21] *Id.* (emphasis added).
[22] *See Watson v. Fort Worth Bank & Trust*, 487 U.S. 977 (1988).
[23] *Id.*
[24] *Hazen Paper*, 507 U.S. at 611.
[25] *Watson*, 487 U.S. at 994 (emphasis added).
[26] *Hazen Paper*, 507 U.S. at 611.

STATEMENT OF KATIE PEARSON
DIRECTOR, HUMAN RESOURCES
ONAN CORPORATION
MINNEAPOLIS, MINNESOTA

SUBMITTED FOR THE RECORD
BEFORE THE SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE
106TH CONGRESS, 2ND SESSION

FULL COMMITTEE HEARING
CASH BALANCE PENSION PLANS
JUNE 5, 2000

I am Katie Pearson, Director of Human Resources of the Onan Corporation headquartered in Minneapolis, Minnesota.

I am submitting this statement for the record on behalf of the Onan Corporation. The purpose of my statement is to supplement the record of the hearing to correct testimony provided to the Committee regarding Onan and its pension plan. In particular, I want to comment on testimony provided to the Committee by Karen W. Ferguson, Director of the Pension Rights Center. Ms. Ferguson indicated in her oral testimony to the Committee that Onan slashed the retirement benefits of its employees when the company converted its traditional pension plan to a cash balance plan in 1989, and that an Onan employee, Stephen Langlie, was fired for complaining about the cash balance plan. Neither statement is true.

With respect to Mr. Langlie, the company asked him, for reasons unrelated to the pension plan, to take a different job at Onan as a result of a 1995 reorganization. The new job would have utilized his skills and experience, and resulted in no reduction in his pay. Many of the duties of his previous job had been eliminated, and the remaining duties had been consolidated with those of another employee of similar age. Mr. Langlie refused to accept the new job. Instead, he left the company and sued Onan. A federal court jury found that Onan did not discriminate against Mr. Langlie based on his age. The court also held that Onan did not retaliate against Mr. Langlie for complaining about his pension. The U.S. Court of Appeals for the Eighth Circuit rejected Mr. Langlie's appeal and affirmed the decision of the trial court. The U.S. Supreme Court refused to hear Mr. Langlie's case. A jury and three different courts have now vindicated Onan's actions. The testimony offered by Ms. Ferguson with respect to Mr. Langlie is directly at odds with the facts as found by our nation's courts.

With respect to the cash balance plan, and contrary to Ms. Ferguson's testimony, Onan's conversion of its traditional pension plan to a cash balance plan in 1989 has provided a better pension for the vast majority of Onan employees, including Mr. Langlie. For many years, Onan generously funded a profit-sharing retirement plan. When profits became uncertain in the 1970's, Onan in 1976 adopted a traditional final average pay pension plan to provide a safety net in case the profit-sharing retirement plan did not produce a healthy retirement income. The traditional pension plan and the profit-sharing retirement plan were structured so that retirees received whichever benefit was greater – the profit-sharing retirement plan benefit or the basic floor benefit under the traditional plan. If the floor benefit was greater, the retiree would receive his or her profit-sharing retirement plan benefit, plus an amount from the pension plan needed to bring the total benefit up to the floor benefit amount. The IRS affirmed its approval of this common arrangement in 1979 and again in 1986.

New tax and pension laws passed by Congress in 1986 forced Onan to consider changes to its traditional pension plan. After careful study, Onan decided to convert its traditional pension plan to a cash balance plan in 1989. Like the traditional plan, the cash balance plan continued to provide a floor benefit with respect to the profit-sharing retirement plan.

In adopting the new plan design, Onan did not attempt to save money. Indeed, it spent more. Although Onan could have frozen its pension plan without continuing to accrue benefits for future service, it did not do so. Onan not only continued to provide a pension benefit, but also made that benefit better. In addition, employees had the value of the old profit-sharing retirement plan.

Onan built subsidized annuities into the cash balance plan to help protect reasonable expectations of longer-service employees. These subsidized annuities were designed to prevent "wear-away," even with respect to early retirement benefits. As a result, most longer-service employees have received a better pension under the cash balance plan than they could have expected under the prior traditional plan. Ironically, these very features are now under attack in other suits brought by plaintiffs, who, like Mr. Langlie, actually do better under the cash balance plan.

Mr. Langlie has said his projected pension of more than $1,000 a month dwindled to a few hundred dollars because of the conversion to the cash balance plan. This is not true. Mr. Langlie fails to acknowledge that his profit-sharing retirement account alone should provide, on average, well over $1,000 a month in retirement benefits. If Mr. Langlie began collecting his retirement benefits at age 65, he could have an income of over $25,000 a year from company-provided benefits under the cash balance and profit-sharing retirement plans. This does not include payments from Social Security and his 401(k) retirement plan account at Onan, to which the company also contributed.

Over the years, Onan has improved its pension plan. For Mr. Langlie alone, the sum total of the improvements has been an increase in annual age 65 income of over $5,000. More than half of this improvement came because Onan converted to a cash

balance plan. As a result, contrary to Ms. Ferguson's testimony, it is not true that Onan slashed the retirement benefits of its employees when it converted its traditional pension plan to a cash balance plan in 1989. On the contrary, the conversion has resulted in better pension benefits for the vast majority of Onan employees, including Mr. Langlie.

Onan has been generous in compensation and benefits to its employees. It addition to its cash balance and profit-sharing retirement plans, the company provides a company match under its separate 401(k) retirement plan. Onan also provides health and dental insurance, short and long-term disability insurance, life insurance, flexible spending accounts, and generous vacation and leave policies.

Thank you for allowing Onan to supplement the record of the Senate Select Committee on Aging's hearing on cash balance plans. Please do not hesitate to write to me if you have any additional questions.

Submitted June 16, 2000

AMERICAN ACADEMY *of* ACTUARIES

STATEMENT FOR THE RECORD

"THE CASH BALANCE CONUNDRUM: HOW TO PROMOTE PENSIONS WITHOUT HARMING PARTICIPANTS"
UNITED STATES SENATE SPECIAL COMMITTEE ON AGING
MONDAY, JUNE 5, 2000

The American Academy of Actuaries (Academy) would like to thank Senator Grassley for holding today's important hearing on cash balance pension plans. The Academy strongly believes that American workers should have access to meaningful information about their pension benefits, especially when changes have been made to their pension plan.

Congress is currently considering proposals that would increase the information employees must receive when their pension plan changes. The Academy believes that any disclosure requirement should provide that employees:

- Receive clear and understandable information about their pensions.
- Know if pension changes are expected to reduce future benefits.
- Be able to compare options and understand the consequences of their choices.
- Be able to request information about their specific situation.

The Academy has developed its own proposal for providing participants with more meaningful information on their pension plan. We stand ready to work with Congress to ensure that workers obtain information to plan for a secure retirement and that America's successful, voluntary private pension system is strengthened.

The Academy has also released an online booklet, "When Your Retirement Plan Changes," to help participants understand how changes to their pension plan can affect retirement planning. The booklet provides basic information on pensions as well as specific information on cash balance plans. The Academy hopes that members of Congress and their staff will refer their constituents to the booklet as a useful resource. Copies of the booklet can be read or downloaded at: www.actuary.org/pub/actuary.org/statement00/cashbook.pdf. Finally, the Academy maintains the Pension Assistance List (PAL), which provides actuarial assistance to organizations that help individuals who have questions about their pension plan.

The American Academy of Actuaries is the nonpartisan public policy organization for the U.S. actuarial profession. The Academy provides independent analysis to elected officials and regulators, maintains professional standards for all actuaries, and communicates the value of actuarial work to the media and public. For more information, see the Academy Web site, www.actuary.org. or contact David Rivera, assistant director of public policy, at (202) 785-7869.

June 7, 2000

Senator Charles Grassley
Senate Special Committee on Aging
631 Dirksen Senate Office Building
Washington, DC 20510

Re: **Cash Balance Plans**

Dear Chairman Grassley:

I wish to present comments pertaining to the Senate Special Committee on Aging's review of Cash Balance Plans.

I began employment with my Bank employer in 1965. I am currently 60 years of age with 35 years of dedicated and faithful service. I chose a banking career partially because of its perceived job security and decent employee benefits. Through the years, my employer had to make occasional amendments to the retirement (defined benefit plan) in order to keep pace with the cost of living.

In 1986, they amended the plan to recognize the contribution made by long service employees. They created a magic number of 85 (combination of years of service and age) that provided for normal (full) retirement at age 60 with 30 years of service and 3% annual reductions for each year that you retired prior to age 60 (between 55 and 60). Even if one did not want to retire at 55, or age 60, the program provided for some financial security, especially in an industry that has been a pacesetter for mergers and acquisitions.

In 1993, under new management, a decision was made to remove the above referenced program. This was done by virtually the same Board of Directors that approved the original plan change in 1986. I understand that the reasoning used was that we were making it too easy for employees to retire early. That makes a lot of sense. Penalize the worker who has already given 30 years of their life to their employer.

In addition, the significance of this change warranted a specific dialogue with the affected employees. However, the change was "swept under the carpet" in the communications that followed the change. I have spent twelve years of my career in a personnel capacity. Thus, I am very familiar with the issue at hand. I, above all, should have picked up the elimination of this plan provision, but did not until much later. I had at least 28 years of the 30 years of service and was within two years of the age requirements. With one flick

of the pen, my financial security was altered when I was in walking distance to the finish line. So much for financial planning. How do you plan for this ???

In looking at the Cash Balance Plan conversion one should not lose sight of the fact that an employee is only ever entitled to their "vested" benefit at any one point in time in a defined benefit plan. There is no law that says that an employer must provide a pension plan. There is no law that says that an employer cannot change the plan, at will, including terminating the plan. I recognized and always understood the issue. However, you would expect in the 1990s that employers would have some resemblance of ethics in handling individual situations like mine.

In 1995, we converted our defined benefit plan into a cash balance plan. The methodology used in the conversion was like "rubbing salt on the wound". With seven (7) years to go for early retirement at age 62, this change impacted me in excess of $230,000 in annuity value. Actually, "the wearing away" concept that was used had me working my last 10 years of employment for no additional retirement benefit. I would have been better off to leave my employer at age 55 and go elsewhere for the last ten years. That makes a lot of sense in plan design !!! In fact, it was possible, depending on interest rates that my "annuity value" at age 65 could have been less than my "vested benefit" at age 55.

Rather than dwell on my own personal tragedy, I want to reiterate first the point I made earlier. There is no law or regulation that requires an employer to offer a defined benefit plan or 401-K plan, period. There is no law that forbids an employer from terminating or amending a program, period. Vesting is what it is all about, period. The issue is not the Cash Balance Plan in itself. The issue is the methodology used in converting the defined benefit plan to the Cash Balance Plan. "He who forgets history is bound to repeat it". Corporate America seems to just never get it ! Why do we have the Wage and Hour Law ? Why do we have the Civil Rights Act ? Why do we have unions ? We could go on and on. The employment proposition is 50 – 50. If either party strays from the 50 – 50, conflict will occur. In this instance, my employer created a 90 – 10 proposition because they shoved the conversion down my throat with no choice or alternative to remain under the former program.

I have written letters to everyone involved in this process from EEOC to various congressional members. I continue to be appalled at the bureaucratic process that has unfolded. EEOC asked for comments late last year. IRS asked for comments. Here is another Committee. The issue has wound up on proxy statements of major corporations. What else needs to be said ? It is time for **ACTION** !!!

Obviously, you have a hot potato and don't know what to do with it. Why not start with a process that it is non-discriminatory against the older employee ? Although I feel their pain, I can't get to excited about the IBM employee who is 38 years of age and was excluded from their recent plan change. That person has 17 to 27 years to modify their financial plan. If the Age Discrimination Act does not respond to this issue, it isn't worth

the paper that it is written on. **It has a blatant and adverse negative impact against a selected segment of the employment community.** Tell me it doesn't !!!

To be honest, I am glad that I will soon be out of this environment. What is sad is that I have had to advise my recently graduated (college) son to never, never put your company before your own personal life and opportunity. Look out for yourself. Don't be like Dad! Look at how he was treated after 30 years with the same company. What have you done for me lately ??? Is that the attitude that Corporate America wants ?

Employers are saying that they have to convert to a cash balance plan because that is what the employee wants. "The employee doesn't stay with the same employer anymore" says the employer. Did anyone stop and think why ? "Build it and they shall come. Repair it, nurture and update it, and they will remain. But never remove the building blocks from the foundation for the walls shall crumble."

After taking $200,000 out of one pocket, my employer now wants to reward me for 35 years of service by putting a $200 gift in the other pocket. And the band marches on with the music lyrics of "our employees are our most valuable assets". This being done while corporate executives are rewarded with obscene bonuses and total compensation packages. They can't see the forest for the trees.

You see, for the last five (5) years I wake up with this on my mind. I go to sleep with this on my mind. And, I work each day with it on my mind. How damaging to one's health. I have tried to cope with this issue by expressing myself in letters such as this. For the most part it has worked. But until you walk a mile in my shoes, you don't know the feeling. You feel no one cares because in the scheme of things we are somewhat in the minority, especially those **significantly** impacted by this change .

I still have these strong feelings despite the fact that my employer has recently addressed the 1995 change and amended the cash balance plan to take away some of the sting. In fact, they went one step farther than most in that rather than give the employee a choice to remain under the old plan, they came up with a formula that will provide a benefit that is the greater of the former program versus the cash balance program. However, even in doing this they could not admit to the travesty that they had done. They pawned off the recent change as having to be done because of negative results from interest rates, i.e. that they expected the returns under the cash balance plan to be greater than what has actually occurred over the last five (5) years. What a joke ! My cash balance plan would have had to get a 30% return to make up the difference. What return did we expect the Five Year Treasury Note to achieve ?

In closing, I would like to say this. I appreciate the effort that the Committee and other similar groups are putting forth. However, I shake my head in disbelief over the **time** and **resources** that are being devoted to this issue without a smattering of indication that we are reaching a consensus of opinion coupled with a resolution plan. God help us if we ever need to address a truly complex matter. Let's form another committee !!!

65-919 2001 - 7

This is far more than a "communications" issue that Congress is trying to push through. I personally didn't need any communication to alert me to the travesty brought upon myself and the rest of the senior workforce. It is about ethics and integrity. It is about righting wrong. It is about fairness. It is about commonsense. This is the beginning of the 21st century. Let's behave as though we learned something over the past hundred years. Do you remember Robin Hood who robbed from the rich to give to the poor ? This system is robbing from the poor (middle class) to give to the rich.

Thanks for listening . . .

Sincerely,

Charles L. Lentz
374 Centerhill Avenue
Linthicum, MD 21090-1908

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Pensions&Investments
The International Newspaper of Money Management
May 29, 2000

View of IBM challenger

▶ Vineeta Anand's May 1 article, "IBM's 1999 pension income bump comes from earnings" is on track, but it vastly understates the vapor profit problem.

The article said IBM's pension fund contributed 5.4% of IBM's pre-tax earnings of $11.8 billion. Besides the article, an accompanying *P&I* editorial points out this money is "in a trust, not easily gotten at by the sponsor." Therefore, "pension income 'is of lesser quality than the rest of . . . earnings'."

I only wish to point out that when year-over-year profit growth and after-tax profit is considered, the magnitude of the problem becomes enormous: 11.5% of IBM's after-tax profit and 39% of IBM's year-over-year profit growth are accounting rule vapor profit from the worldwide pension fund surplus after the one-time sale of IBM's Global Network to AT&T is excluded.

It is appropriate to consider what fraction of after-tax profit and after-tax profit growth pension income is providing. An actuary friend of mine who is an expert in FAS 87 says the pension money reported as income is not taxed along with other company income. Therefore, the report of profit from the pension fund goes right to the bottom line after taxes. FAS 87 income is the perfect form of income: No tax, no salaries, no expenses, no product to build, no sales to worry about, no inventory, no advertising, no workers. It's just income, right on the bottom line after taxes.

Of course, there is one problem. IBM can't touch the money. But as long as the stockholders don't understand that, management looks great.

Year-over-year profit growth is the key parameter for determining stock price-to-earnings ratio. Thus, the stock price is very sensitive to the report of vapor profit growth, and stockholders are at risk if companies pad the report of profit with money that must remain in the pension fund.

Since pension fund surplus is one of IBM's fastest growing units, the problem is compounded. For example, IBM's actual year over year profit growth was only 6.1% when the one-time sale of the Global Network and the vapor profit are excluded, and this is much less than the 22% growth IBM touted in the annual report.

The editorial notes that the SEC issued an accounting directive requiring IBM and other companies to fully disclose pension contributions in the management discussion section of the annual report. The editorial then notes that IBM failed to follow this directive and that the SEC shrugged off IBM's failure to follow the SEC directive.

I believe that if IBM clearly explained that 11.5% of its profit and 39% of its profit growth are not transferred to IBM and must remain in the pension trust fund, the motivation to slash pensions would be substantially eliminated. There is a $17 billion surplus in IBM's $73 billion pension fund, and the surplus nearly doubled in 1999. IBM has not added money to the trust fund in several years. The major driver for slashing retirement pay for employees is the fact that IBM can pad its profit and profit growth from the pension fund surplus while keeping the padding secret from stockholders. The cash balance plan conversion took at least $100,000 of retirement pay away from each of nearly 100,000 employees, or about $10 billion in all. IBM is robbing employees to deceive stockholders.

Although the profit IBM is reporting is a vapor profit, the damage to the IBM corporation and to IBM employees is real. Padding company profit with a report of money that still remains in the pension fund is not good reason for employees to be impoverished in their old age. Employee morale and IBM's reputation for honesty were both hurt.

Because of these considerations ISS, Proxy Monitor, Marco and Proxy Voter Services all recommended that their institutional clients vote for the stockholder resolution I wrote. That is why the resolution got a vote of nearly 300 million shares or 28.4%. This was one of the largest votes ever on any stockholder resolution at IBM.

I agree with *P&I* that the SEC must follow through on its requirement that management disclose the boost to profit and the contribution to profit growth from the pension fund. I would further recommend that the SEC and FASB eliminate reporting of pension fund money as corporate profit. I believe IBM's motivation to slash pensions would evaporate if it could no longer report pension fund money as IBM profit. IBM would then find value in using its huge self-funding pension fund as it was intended, as competitive advantage to attract and retain talented employees at no cost to the company.

James Marc Leas
advisory engineer,
IBM Microelectronics Division
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MARKET WATCH

GRETCHEN MORGENSON

What's Hiding in Big Blue's Small Print

AT first glance, the 30 percent growth in operating income that I.B.M. booked last year looks impressive.

Closer inspection, though, shows that just under a third of the increase came from I.B.M.'s employee pension plan. The combination of a roaring stock market and lower costs associated with I.B.M.'s controversial switch to a new sort of pension plan generated $799 million in 1999. Accounting rules let such gains go into a company's income statement, although the company cannot spend the money for anything but pensions.

Gains like these are doing more and more for corporate earnings. In 1996, pension fund growth amounted to just 1.8 percent of I.B.M.'s operating income. Last year, the pension contribution was 6.7 percent.

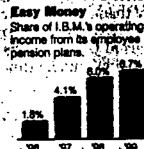
Because these gains are typically buried in financial statements, shareholders may not understand how a company's earnings are augmented by pension gains.

To highlight this and other financial reporting concerns, Lynn E. Turner, chief accountant of the Securities and Exchange Commission, sent a letter to the American Institute of Certified Public Accountants last December. Well before annual report season, Mr. Turner identified problem areas that could obscure a company's true financial picture. He warned auditors to be alert to the issues when preparing financial statements for their corporate clients.

Mr. Turner's letter said that if a company changed its pension plan, or if the plan's gains or losses were likely to have a material impact on the company's financial condition, liquidity or results, the information should appear up front in the "Management's Discussion and Analysis" section of the annual report, not back in the footnotes.

So why do the gains attributable to I.B.M.'s pension plan appear only in Footnote W?

Jimmy Leas, an I.B.M. employee and shareholder, has been asking just that question. Last Thursday, Mr. Leas, an advisory engineer for I.B.M. in Burlington, Vt., queried Louis V. Gerstner Jr., I.B.M.'s chairman, about it by e-mail.



By late Friday, Mr. Leas had not heard back. Asked by a reporter why the pension details were not in management's discussion and analysis, Carol Makovich, an I.B.M. spokeswoman, said, "In terms of changes year to year, we don't believe it is quantitatively or qualitatively material." Ms. Makovich added that I.B.M.'s reporting is in strict compliance with accounting rules.

To be sure, I.B.M. is just one of many companies that continues to bury details about its pension plans' gains. But Big Blue could be clearer. Though still in a footnote, General Electric was much more direct, for example. G.E.'s report made it obvious at a glance how much pension income contributed to operations.

"I.B.M.'s annual report is one of the most complicated," said Brad Perry, former chairman and now consultant at David L. Babson & Company, an investment advisory firm in Cambridge, Mass. "Obfuscation is the name of the game, not just for I.B.M. but for a lot of companies."

Another area of I.B.M.'s financial report that is difficult to fathom concerns stock buybacks, which have totaled $14.2 billion in the past two years. By reducing the number of shares outstanding, the buybacks have helped I.B.M.'s per-share earnings grow at a respectable 10.5 percent — masking the company's slow growth in revenue and income, Mr. Perry said.

But the purchases come at a cost, he added: I.B.M.'s ratio of debt to total capital is 54 percent, up from 31 percent four years ago.

"It's one thing to buy back shares if you have excess cash flow," Mr. Perry said, "but when you're loading up the balance sheet with debt to jazz up your earnings, that's more suspect. And it certainly is a game that has an end."

Perhaps the S.E.C. will follow up its words with action. But shareholders should be vigilant for accounting gimmicks regardless. After all, not all earnings are equal. □

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NEWS ANALYSIS

The Down-Aging of Pension Plans

With the official unemployment rate low, and many large corporations in a hiring mood until very recently, the reality of the last round of work force downsizing has become evident. Downsizing was really down-aging. Fifty-five-year-old office workers were pushed aside in favor of generation X members.

So what if a 25-year-old lacks the experience of his older counterpart? Most white-collar job performance criteria are highly subjective, and younger workers are cheaper. In the seniority system that prevails in most large corporations, older workers have to be paid more, and their medical benefits cost more, and they accrue pension benefits at a higher rate. (In the old days, when all workers were male, this was an explicit subsidy for male-supported families.) Put a younger worker in the same job, and those medical and pension costs are greatly reduced. Except that generation X turned out to be better savers than their parents, the notoriously spendthrift baby boomers, were. And generation X members are not happy with the indefinite pension benefits traditionally offered to younger workers. Moreover, they tend not to understand any pension concept that does not look like an individual account plan with an identifiable lump sum that belongs to them.

> ***Converting companies view the change as a way to spread a limited number of dollars more evenly across a population of employees.***

Pension consultants think they have the answer. What is known as a "cash balance" pension plan has the effect of reducing the pension accruals of older workers while increasing the accruals of younger workers. In the conventional back-loaded pension plan, much of the value of a worker's pension accrued in the last five years before retirement. In a front-loaded cash balance plan, compounding interest on accruals means far lower accruals for older workers and higher accruals for younger workers, though the accruals are facially level. So once a cash balance plan is installed, older workers who were staying on to accrue the maximum pension benefit may even leave without being explicitly pushed, while younger workers are happy with what they perceive as an individual account plan. (The individual account analogy is pushing it. See *The Wall Street Journal*, Dec. 31, 1998, p. C1.)

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Hundreds of large companies with conventional pension plans in place — it's too expensive to terminate them — have switched to a cash balance format, according to *The Wall Street Journal*, enabling some to cut their pension costs by so much that they do not have to contribute to their plans for a while. Notable converts to the cash balance format are the Bells (Ma and Babies both), which found themselves having to compete with younger communications companies and saddled with pension plans that subsidized both long service and early retirement. Converting companies view the change as a way to spread a limited number of dollars more evenly across a population of employees. Although the promised pension at retirement in a cash balance plan is lower than that of a conventional defined benefit plan — 20 percent of final pay, say, instead of 30 percent — the likelihood of collecting something is greater because cash balance plans pay lump sums to employees who leave after five to 10 years, while conventional defined benefit plans typically do not. That is, the conventional pension plan functions somewhat like a tontine, rewarding the few who hang on the longest.

Employees are being notified of the change in oblique ways in some cases, so that they may not fully understand the change. (*The Wall Street Journal*, Dec. 4, 1998, p. A1, and Dec. 18, 1998, p. C1.) Most employees, that is. Employees at a Big 5 accounting firm that converted understood the change — they are, after all, being paid for their financial sophistication — and were not happy about it. (Should the firm have fired accountants who couldn't figure it out and did not complain?)

Cash balance plans present two problems for the IRS and the Labor Department, which share administration of ERISA. First, the plans may violate rules designed to prevent age discrimination in benefit accruals and reductions in benefits. Second, the two departments, in allowing hundreds of large companies to convert conventional defined benefit plans to cash balance plans without a thorough study of the matter, may have effectively foreclosed their options for dealing with those plans, even if the ultimate decision is to bless them. The sponsors of the converted plans seem to have taken the view that their plans are too big to fail — that is, too big to have their exemptions challenged by the IRS. The history of the pension rules would justify that view; not only has no big plan ever been disqualified, but much of the nondiscrimination rules were written to accommodate the existing practices of big plans.

What is the IRS doing about cash balance plan conversions? Basically, the IRS has decided to accept the conversions and has tried to accommodate cash balance plan sponsors within the letter of the law. Regulation section 1.401(a)(4)-8(c) provided a little-used safe harbor so that cash balance plans could satisfy the rules prohibiting too much discrimination in favor of highly paid participants. The preamble to the 1991 proposed nondiscrimination rules (EE-22-90) seemingly lets cash balance plans off the hook on the age discrimination question. More recently, Notice 96-8, 1996-1 C.B. 359, accommodates some of the plan sponsors' desires in cash-out calculations. Further guidance on cash balance plans is on the 1998 business plan, but its release is not imminent.

But more than this, the government's policy has been to let the questions raised by cash balance plan conversions slide, while pension consultants lobby to have the rules read in their favor or changed. In the wake of the publication of unflattering articles about these conversions in *The Wall Street Journal*, Senate Finance Committee minority members have expressed interest in addressing the employee communications problem, and implicitly the related age discrimination question. (See *Tax Notes*, Jan. 4, 1999, p. 41.)

The Conversions

Employers have great discretion in what kind of retirement plan they set up, whether to contribute to it, and whether to establish any retirement plan at all. This article is not about whether an employer could set up a cash balance plan *ab initio*. The question is whether, once an employer has a conventional pension plan in place, the plan can be converted to a cash balance plan without running afoul of rules prohibiting age discrimination and benefits reductions.

> ***The question is whether a conventional pension plan can be converted to a cash balance plan without running afoul of rules prohibiting age discrimination and benefits reductions.***

Put more simply, the question is whether there is age discrimination against the older participants who are in place when a back-loaded conventional defined benefit plan is converted to a front-loaded cash balance plan. Some lawyers believe there is an age discrimination problem, and older participants in converted plans are suing on this basis under section 4(j) of the Age Discrimination in Employment Act and section 204(g) of ERISA. Even though converting employers may regard the front-loaded formula of a cash balance plan as a more equitable way to allocate benefits, the law does not look favorably on a change that has a detrimental effect on older employees. Another, related age discrimination

question is whether the design of a cash balance plan itself could be discriminatory, because the rate of benefit accruals declines as any employee gets older.

A defined benefit plan, as its name indicates, defines a pension benefit that an employee earns through years of service. There are no individual accounts in a defined benefit plan, as there are in a defined contribution plan; there is just one big pot of money set aside in trust, from which the defined benefits will be paid. The plan sponsor's annual contributions to the fund vary with the ages and salary histories of its employees, the performance of the fund's investments, and legal requirements that set both floors and caps on the amount of contributions. The conventional defined benefit plan is back-loaded in that benefits are defined by a formula that uses the average of each participant's highest-earning years. So employees nearing retirement, and earning at their peak, could be earning as much as half of their eventual benefit. That means that the employer's required contributions go up. (Indeed, the conventional plan is so back-loaded that there are rules restricting the degree of back-loading.)

The nearly retired, and especially early retirees, can easily be the costliest part of a conventional back-loaded defined benefit plan in terms of required contributions. In some conventional defined benefit plans, early retirement subsidies can account for as much as half of current funding requirements. In 1985, a desperate Bank of America took the advice of the then little-known pension consulting firm Kwasha Lipton to convert its conventional defined benefit plan to a cash balance plan. The badly managed bank, cruelly nicknamed "Bankrupt of America" at the time, had nothing to lose, because it could not afford plan contributions. If the Labor Department and IRS disapproved of the conversion, the bank would have to make up the deficiencies of the plan. And if things got really bad, the PBGC would take over the plan. (Kwasha Lipton, which now belongs to PricewaterhouseCoopers, built its business on cash balance conversions.)

A cash balance plan is still legally described as a defined benefit plan. But unlike a conventional defined benefit plan, a cash balance plan makes hypothetical allocations to a hypothetical individual account (the "cash balance") for each participant. The employer hopes to limit its liability under the plan to the amount in each participant's account when the participant leaves, but Notice 96-8 prevents that. (And ironically, even though a switch to a cash balance plan can cut the employer's required contributions drastically, the design of cash balance plans means that they tend not to be sufficiently funded on a termination basis. Terminations of cash balance plans are, in the words of one actuary, "not pretty.")

It is useful to compare the benefit formulas of conventional defined benefit plans to those of cash balance plans. A conventional defined benefit plan does not include an interest component in the formula that defines the benefit, which makes sense since the participant has no individual account. The usual formula is final average pay (or career average pay) times years of service times a rate, usually in the single digits. That formula will produce a monthly retirement benefit beginning at normal retirement age. Actuaries can project the monthly retirement benefit beginning at normal retirement age to estimate the plan's eventual liabilities.

> ***The sponsors of these plans are trying to have it both ways. They want the limited liability of a defined contribution plan and the flexible funding of a defined benefit plan.***

A cash balance plan uses a different formula. For each year, each participant earns a rate of his or her compensation, called a "pay credit," usually a single-digit percentage of compensation. The pay credit can be level for all age groups; or if the sponsor wants to ameliorate the front-loading somewhat, the pay credit can be graduated, lower for younger age groups and higher for older age groups. It does not matter. The front-loading effect of the next element of the formula, the interest credit, will vastly outweigh the back-loading effect of a graduated pay credit schedule. Cash balance plans and their ilk, travelling under names like "pension equity plans," provide for hypothetical interest accruals on a participant's account. The interest factor may be stated, as in cash balance plans, or unstated, as in pension equity plans.

Each year, each participant earns an interest credit on that year's pay credit and all prior years' pay credits and interest credits, as though the participant had an individual account. (Delaying the interest credits, as some cash balance plans do, causes the plan to fail requirements against back-loading.) Most cash balance plans use a variable interest rate for the interest credits, tying it to an index like one-year Treasury bills. A plan may also base its annuity conversion factor on a variable interest rate. Each participant's hypothetical account is the sum of the accumulated pay credits and interest credits. By crediting an interest rate that is lower than

what the plan earns on its investments, the employer can keep the difference, saving money through interest rate arbitrage. (The benefit of arbitrage is why, in some cases, employers have chosen to establish a cash balance plan *ab initio* instead of a defined contribution plan. In a defined contribution plan, all investment gains belong to participants; there are no unallocated amounts.)

The miracle of compound interest is what makes cash balance plans front-loaded, and what makes them more favorable to younger employees than to older employees. Because of interest compounding, the *rate of benefit accrual* in a cash balance plan declines, because each year's pay credit will earn one less year of future interest credit. As this article will demonstrate, this built-in decline in the rate of benefit accrual is the key to the age discrimination question raised by cash balance plans. Notice 96-8 makes the important point that the accrued interest credit in a cash balance plan is nonforfeitable part of each participant's accrued benefit, rather than being some sort of ancillary benefit, as the sponsors would prefer. This means that payment of the interest credits that have been earned is not discretionary on the plan sponsor's part.

A variant on cash balance plans, participant-directed plans, ties the interest credit to the performance of an index selected by the participant, such as the Standard & Poor's 500 or the Fidelity Magellan Fund. Structurally, participant-directed plans operate the same way as cash balance plans do. A so-called "pension equity plan," however, defines the pension benefit not in terms of a hypothetical account balance with interest credits, but rather as a hypothetical lump sum, which, at any age, is defined in terms of the participant's years of service times final pay times a single-digit percentage rate. Though this formula looks similar to that of a conventional defined benefit plan, the point is that the sponsor and the participant are viewing the benefit in terms of a lump sum — which is not the way the law sees it.

Although sponsors of cash balance plans use lump sums for purposes of calculating benefits, the law governing defined benefit plans does not. Lump sum calculations are irrelevant to calculations of rates of benefit accrual. But the promoters of cash balance plans are working to persuade the tax administrator to let them apply the rules as though these defined benefit plans were defined contribution plans. That is, the sponsors of these plans are trying to have it both ways. They want the limited liability of a defined contribution plan and the flexible funding of a defined benefit plan. (If defined benefit plan's demographic profile or investment performance is favorable, no contribution may be required in some years.)

Age Discrimination

Unlike a conventional defined benefit plan, a cash balance plan does not, by its own formula, define a deferred annuity. That is, the formula does not establish what is known as a rate of accrual for a normal retirement benefit. Indeed, the amount of a participant's deferred benefit due under a cash balance plan cannot be known with certainty until the participant reaches age 65, particularly if the plan is using a variable index for its interest credit, as most such plans do.

Nonetheless, the law governing defined benefit plans, and in particular the rules regarding age discrimination, contemplates that rates of accrual can be derived for every kind of defined benefit plan. Indeed, Notice 96-8 states that sponsors of cash balance plans have to derive an accrued benefit, and further that they have to assume worst-case scenarios when they make that estimate.

Section 4(i)(1)(A)of the Age Discrimination in Employment Act (ADEA) states, in pertinent part:

> Except as otherwise provided in this subsection, it shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit plan which requires or permits . . . in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age.

Section 204(b)(1)(H) of ERISA states:

> Notwithstanding the preceding subparagraphs, a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age.

Code section 411(b)(1)(H) states in pertinent part:

> (H) Continued accrual beyond normal retirement age. (i) In general. Notwithstanding the preceding subparagraphs, a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age. (ii) Certain limitations permitted. A plan shall not be treated as failing to meet

the requirements of this subparagraph solely because the plan imposes (without regard to age) a limitation on the amount of benefits that the plan provides or a limitation on the number of years of service or years of participation which are taken into account for purposes of determining benefit accrual under the plan.

The key words in these three similar statutes are "rate of benefit accrual," a term that is not specifically defined but often invoked in discussions of the section 415 limits on contributions and benefits. The rate of accrual should not be confused with the rate of the pay credit or the multiplier in a conventional defined benefit formula. The rate of accrual measures what is happening each year as a participant earns a retirement benefit. A related concept, "accrued benefit," is a defined benefit expressed as an annual retirement benefit beginning at normal retirement age. This is not a lump sum. It is a projection, based on that age of the participant and his earnings, of what annual benefit will be due at normal retirement age; that is, age 65. "Rate of benefit accrual" and "accrued benefit" get at the same thing — what benefit will a participant have at 65, and how fast is he or she earning that benefit?

Code section 411(a)(7), for purposes of section 411 vesting and accrual rules, defines "accrued benefit" in the case of a defined benefit plan as "the employee's accrued benefit determined under the plan and, except as provided in subsection (c)(3), expressed in the form of an annual benefit commencing at normal retirement age."

Regulation section 1.411(b)-7(a)(1)(ii)defines "accrued benefit" in a defined benefit plan that does not specify a benefit as: "an annual benefit commencing at normal retirement age which is the actuarial equivalent determined under section 411(c)(3) and section 1.411(c)-(5) of the accrued benefit determined under the plan."

Code section 411(c)(3) provides that:

> For purposes of this section, in the case of any defined benefit plan, if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age . . . the employee's accrued benefit . . . shall be the actuarial equivalent of such benefit or amount determined under paragraph (1) or (2).

Regulation section 1.411(c)-1(e) reiterates: "In the case of a defined benefit plan . . . if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age, such benefit . . . shall be the actuarial equivalent of such benefit, as determined by the Commissioner."

In the simplest possible terms, these statutes and regulations mean that the law does not define the accrued benefit in a cash balance plan the same way the cash balance plan defines it. At a minimum, this means that the sponsors of cash balance plans have to redefine their benefits in accordance with the law, as the actuarial equivalent of an annual benefit commencing at normal retirement age, for purposes of determining whether their plans satisfy the section 411 requirements. The cash balance plan sponsors, however, insist that the conflict in the definitions should not change what they have to pay to participants.

> ***The use of an interest factor means that while younger workers have their accruals continually raised by the effect of compounding, older workers at the time of the conversion see their rate of accrual leveled off or even reduced.***

Superficially, a cash balance plan with level pay credits does not discriminate on the basis of age; everyone gets the same percentage of pay set aside and the same interest rate credited to it. But when these pay and interest credits are projected forward to produce an annuity commencing at normal retirement age, the age discrimination becomes plain. As previously explained, a younger worker will have more years of interest credits, and the effect of compounding produces the differences in the eventual benefit. The use of an interest factor in the defined benefit formula of cash balance plans means that while younger workers have their accruals continually raised by the effect of compounding, older workers at the time of the conversion see their rate of accrual leveled off or even reduced. On the conversion of a conventional defined benefit plan, older employees may lose the back-loading of benefit accruals in that design. So older employees stand to lose at both ends on the conversion of a conventional defined benefit plan to a cash balance plan.

There are 1988 proposed regulations designed to implement section 411(b)(1)(H) which do not specifically address the cash balance plan question. But the general approach of proposed regulation section 1.411(b)-2 indicates what the answer might be. In these regulations, the IRS has read section 411(b)(1)(H) narrowly to prohibit

employee no more than the amount that has accumulated in his or her hypothetical account. The trouble is, the law does not think in terms of cash balances. The law requires that the departing employee's accrued benefit be projected out to an annuity commencing at normal retirement age and then discounted back to present value to determine the appropriate lump sum to be paid. Section 417(e) prescribes interest rates that must be used in discounting the projected benefit to present value. The section 417(e) blended rate is sometimes lower than the rates used by cash balance plans for calculating interest credits, so that the result arrived at from projecting forward and discounting back can be *larger* than the amount of the employee's hypothetical account. For example, if the plan grants interest credits at 6 percent, and the section 417(e) rate is 4 percent, the lump sum required to be paid on departure will be higher than the employee's cash balance. Employers hate that. They call it "whipsaw."

If no more than the employee's hypothetical account balance is paid on his or her departure in a whipsaw situation, then there will have been an impermissible forfeiture of benefits under section 411(a). Notice 96-8 provides a bit of relief for the sponsors of cash balance plans while maintaining the principle that the law governing cash outs of accrued benefits has to be followed even when it conflicts with the plan's practices. Noting that most cash balance plans index their interest credits to unpredictable Treasury rates, the IRS in the notice specified acceptable indices for projecting future interest credits for purposes of deriving an annuity commencing at normal retirement age. Thus the IRS decided to permit small interest rate spreads at which no impermissible forfeiture will be deemed to occur if the departing employee is only paid his or her hypothetical account balance. Basically, the notice makes life more comfortable for the sponsors of cash balance plans by permitting then to compel some departing employees to make small and otherwise impermissible forfeitures.

The IRS has tried to accommodate cash balance plans in other ways. The nondiscrimination safe harbor testing method for cash balance plans is provided under the cross-testing rules of reg. section 1.401(a)(4)-8(c), permitting cash balance plans to be tested for discrimination in favor of high-paid employees as though they were defined contribution plans. The safe harbor testing method permits a cash balance plan to be tested on the basis of the hypothetical allocation formula used to determine an employee's cash balance, rather than on the actual benefits provided under the plan, if certain conditions are satisfied. Sponsors of these plans still, however, find even this safe harbor overly restrictive, and typically try to fit themselves within a benefit accrual rule meant for career average pay defined benefit plans.

The preamble to the proposed 1991 nondiscrimination rules contains the IRS's only statement thus far about the age discrimination question raised by cash balance plans. The preamble states: "The fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan." The rules in question, promulgated under section 401(a)(4), are designed to prevent too much discrimination in favor of the highly paid, making this sentence *obiter dicta*.

As this article has demonstrated, the effect of compound interest is precisely what causes the age discrimination problem. In this preamble, the IRS appears to be saying that the very thing that causes the age discrimination problem does not cause an age discrimination problem. To the extent that it means anything, the sentence only refers to the plan design, not the question of transition from defined benefit plan to cash benefit plan. Yet plan sponsors everywhere rely on this sentence to say that they have no age discrimination problems on the conversion of a conventional defined benefit plan to a cash balance plan — a time at which, as this article has demonstrated, the age discrimination issue is most clearly raised.

This preamble does not have the force of law, and no judge would give it that effect. But the age discrimination sentence, *dicta* though it may be, does have a very profound practical effect. For nearly a decade, it has meant, in practice, that the IRS will not deny a determination letter to a defined benefit plan converting to a cash balance format on the ground of age discrimination. Basically, the IRS ignores the age discrimination question in evaluating a determination request from a converting plan. And a converting plan must request a new determination, because a switch to a cash balance format is an amendment.

The upshot of this reading is that plan sponsors have no reason to care about the age discrimination question, at least insofar as their tax qualification is concerned. The preamble cannot prevent employees from suing for age discrimination under ADEA or ERISA. The fact that the preamble is only a preamble, and *dicta* at that, so that the government could change its mind about the age discrimination question in the future, matters not to plan sponsors who would be

entitled to section 7805(b) relief if the answer changed. Though there have been delays in getting determination letters for cash balance plans, there has been no stoppage in their issuance.

> ***The complacency about this preamble dicta is startling. Everyone seems to regard the age discrimination question as settled, and in need of no further official elaboration.***

What were the drafters of the preamble sentence thinking? They had come to a conclusion that there was no age discrimination problem in cash balance plan design, especially compared to the heavy favoritism of long-serving, older employees that is typical of conventional defined benefit plan designs. They had concluded that cash balance plans should be tested for age discrimination the same way they were tested for discrimination in favor of the highly paid — as though the plans were defined contribution plans. Thus the accrued benefit should be evaluated on a present value basis rather than on a projected benefit basis.

The drafters of the preamble just didn't bother to state any of this reasoning in a binding official document, nor have their successors bothered to confirm the conclusion. Indeed, the complacency about this preamble *dicta* on both the government and private sides of the equation is startling. Everyone seems to regard the age discrimination question as settled, and in need of no further official elaboration. "Why should the government say any more?" was the reaction on both sides.

A conversion to a cash balance format could be a horizontal partial termination of a defined benefit plan under section 411. Partial termination would be a question if the plan was in surplus, and if the conversion resulted in a significant decrease in the overall rate of future benefit accruals. The partial termination rules were designed to prevent employers from reducing accruals in the quest to recover a defined benefit plan surplus. The remedy for a partial termination would be faster vesting of previously promised benefits, which, in the face of required five-year vesting, is not a big deal.

Is the IRS afraid to disqualify a cash balance plan? The IRS is, generally speaking, afraid to disqualify any large plan. If the IRS read section 411(b)(1)(H) as broadly as some plaintiff's lawyers would like, every cash balance plan would risk disqualification on age discrimination grounds because, as this article has explained, even a graduated pay credit schedule cannot compensate for the effect of compounding interest.

Given that the sponsors of cash balance plans want the best of both worlds — ownership of the funds of a defined benefit plan and the limitation of liability that comes with a defined contribution plan — is there a point when a cash balance plan crosses over into defined contribution territory? Clearly, under the law, no. A disqualified defined benefit plan is a just disqualified plan. It cannot be a defined contribution plan because the trust funds have not been allocated to the participants. (Though a disqualified defined contribution plan can qualify as a defined benefit plan by default, because any plan that is not an individual account plan is a defined benefit plan.) This is why the IRS approach, as reflected in Notice 96-8, has been to try to hold cash balance plan sponsors to the defined benefit plan rules.

Legislation?

Which rather limited IRS effort the plan sponsors resent, deeply. Until the recent *Wall Street Journal* articles appeared, the only talk of legislation in reference to cash balance plans was the attempts by plan sponsors and consultants seeking legislation to grease the skids for cash balance plans. As indulgent as the IRS has been, the sponsors of cash balance plans have not been satisfied. They want the unfettered privilege to run their cash balance plans as they see fit, as though they were defined contribution plans, only without terminating the existing defined benefit plan and without the funds belonging to the employees. They want to have their cake. And these are very large plans, because the trend has been for the sponsors of conventional defined benefit plans, most of which were large employers, to convert. So these large employers have a lot of political muscle.

The appropriate narrow response, which would require legislation, would be to deem cash balance conversions to be terminations of defined benefit plans followed by establishments of defined contribution plans. Employers who want limited liability should be required to allocate all their funds to participants. The hybrid of limited liability and employer ownership of the funds is contrary to the ERISA design that set individual account plans apart.

Before it attacks cash balance conversions, however, Congress should be mindful of how little the reams of federal pension plan rules have accomplished in the way of actual delivery of retirement security. One cannot be too nostalgic for the old conventional defined benefit plan, which provided huge benefits to a fortunate few.

cessations and reductions in benefit accruals that are made on the basis of the attainment of a certain age. Section 411(b)(1)(H) was primarily intended to prevent the practice of ceasing benefit accruals for workers who stayed on past the age of 65. The statute and the proposed regulations permit all sorts of changes that have the effect of discriminating against older workers but that have not been made on the basis of age. So a plan design that limits the years of service taken into account in determining defined benefits, though it deleteriously affects older workers, is legal because age was not the deciding factor in this limitation. (Prop. reg. section 1.411(b)-2(b)(2)(i).)

Proposed regulation section 1.411(b)-2(a) states in pertinent part:

> A defined benefit plan is not considered to discontinue benefit accruals or reduce the rate of benefit accrual on behalf of a participant because of the attainment of any age in violation of section 411(b)(1)(H) . . . solely because of a positive correlation between increased age and a reduction or discontinuance in benefit accruals or account allocations under a plan.

The same proposed regulation does, however, prevent plan sponsors from "indirectly" conditioning cessations or reductions in benefit accruals on the attainment of a certain age. This means that, for example, benefit accruals cannot be cut off because a participant has become eligible for social security benefits. (Prop. reg. section 1.411(b)-2(b)(2)(ii).) But it is permissible to have a lower rate of benefit accrual for the last 15 years of credited service than for the first 15 years of credited service in a defined benefit plan, even though the employee with the reduced accruals is going to be an older employee. (Prop. reg. section 1.411(b)-2(b)(3).) That is, a permissible limitation on benefit accruals should be determinable by reference to something other than age. The proposed rules also permit adjustments to the accruals of employees who work beyond normal retirement age, basically preventing them from enlarging their pensions by doing so. Section 411(b)(1)(H) permits those limitations, as do its ERISA and ADEA counterparts.

These proposed regulations give a very narrow reading to the phrase "because of the attainment of any age" used in section 411(b)(1)(H), precluding a finding of age discrimination when the effect of a facially fair practice is discriminatory. And the IRS interpretation of the age discrimination rules governs the approach of the Labor Department and Equal Employment Opportunity Commission. (ADEA section 4(i)(7); ERISA section 204(b)(1)(H)(vi); section 101 of Reorganization Plan No. 4 of 1978; section 9201 of the Consolidated Omnibus Budget Reconciliation Act of 1986.) The EEOC, for its part, is waiting for the IRS to promulgate final age discrimination regulations before it incorporates the IRS conclusions into its own ADEA regulations. Cash balance plans were not common when proposed regulation section 1.411(b)-2 was drafted, so the government could change its approach in final regulations.

Would a cash balance plan fail the test of proposed regulation section 1.411(b)-2? Facially, cash balance plans look evenhanded; every participant either has the same rate of pay credit or, more often, the pay credits are graduated with larger credits going to older workers. It is the compound interest that makes these plans more valuable for younger workers. Whether a cash balance plan would satisfy the proposed regulation depends on the definition of "rate of accrual." If rate of accrual is defined by projecting the participant's benefit to an annual benefit beginning at normal retirement age, then cash balance plans flunk, because the size of a participant's actuarially determined benefit is purely a function of his or her age. Indeed, it is impossible to estimate a cash balance plan participant's pension benefit without knowing his or her age. If cash balance plans were tested for age discrimination as they are for discrimination in favor of the high-paid, as though they were defined contribution plans under the safe harbor of regulation section 1.401(a)(4)-8(c), then no age discrimination would be found.

IRS Response

The conflict between the cash balance plan sponsor's view of what is due the participant and the law's view is clearly evident in Notice 96-8, which discusses what amount should be paid to a participant in a cash balance plan who is being cashed out because he or she is leaving the company. In an era of diminished loyalty on both sides of the employment equation, cash-outs are no small matter. Cash balance plans appeal to companies that have high employee turnover, like computer software companies and financial intermediaries. Indeed, a significant design feature of cash balance plans is their ability to derive some sort of sum to pay a departing employee, unlike conventional pension plans, which typically pay nothing to employees who leave after only a few years. (Aren't cash-outs bad retirement policy? Of course they are. But good retirement policy is regarded as old-fashioned and paternalistic.)

When an employee leaves, the sponsor of a cash balance plan wants to be able to pay the

Frank Wright
618 Rescobie Dr
Schererville IN 46375-2980
June 9, 2000

Senate Special Committee on Aging
631 Dirkson Senate Office Building
Washington, DC 20510

Dear Committee on Aging,
My name is Frank Wright; I am a Senior Maintenance Planner for Ispat Inland Blast Furnace in East Chicago Indiana. I have been involved in the pension controversy at Ispat since the company went to a Cash Balance Plan at the end of 1999. At Ispat/Inland (which is foreign owned), The Plan was converted to a frozen annuity (at 7% rate) and a new beginning cash balance. Information was given explaining the change and it caused quite uproar with all affected. This was the non-represented group of employees only. The union group was not affected. The sweeteners that were given to Central and South West corp. were not given here at Ispat. No 15 percent raise and NO increase in our 401 K was offered. The plan was subsequently changed adding a 400 dollar sweetener and a 52$ a year for each year after 1999.

The problem is that the enhancements can be changed at any time leaving my group, which is 95% of the salaried employees with a frozen pension. The testimony given so far shows a company that improved the benefits but has no legal responsibility to keep these enhancements. This leaves a lot of middle aged and older folks with a paltry pension. The pension plan was something that has been taken for granted for the last 28 years that I have been with this company. (A Company founded in 1895) Changing the plan on the folks at Inland, most that are in there mid to late 40's is like moving the target in a archery contest once the arrow is in flight. It is NOT RIGHT. Please, do not think for one moment that the examples given are the norm or that the examples can not change with any liability once these hearing are over. Our Company Executive telling of the change told our group " We are changing this plan because we CAN. " It is legal and there is nothing you can do about it. So far he has been right. There is much more about this subject that I can comment on but I know you have many letters to review. Please understand that this letter is from 1200 employees at Ispat Inland Steel.

Thanks for your time.

Frank Wright
Director Inland Pension Plan Association
Ispat Inland Steel
fw

Jim E. Matthews
2373 McCloud Street
Denver, North Carolina 28037

Senate Special Committee on Aging
631 Dirksen Senate Office Building
Washington, DC 20510

June 12, 2000

Gentlemen:

Thank you for allowing testimony regarding cash balance pension plans. I am a Nuclear Instrumentation and Control Specialist and have been employed by Duke Energy Corporation for approximately twenty-nine years.

Duke Energy's cash balance conversion was implemented January 1, 1997. Only employees aged fifty on that day were allowed a choice of plans. I missed the cut off date by thirty-six days. I do not believe that the cut off age was selected by accident. I believe that it was deliberately calculated to deprive the maximum number of employees of their earned pension benefits. I am on the leading edge of the baby boomers. That means that virtually all of the boomers will lose significant pension benefits. We lost our early retirement benefit. We truly received the worst of both plans.

I take issue with the statement that employees did not value their old pension plan. Just who dreamed this up? I have had unsolicited job offers during my career with Duke Energy. The pension plan is the single reason that I stayed with the company. The employees that I have talked to feel the same way. We do not appreciate having a quarter of a century's worth of promises thrown away and being offered a silly list of reasons why. Great effort was spent in devising a way to deprive us of our earned pensions. It seems that the *supposed* reasons were just thrown out as an afterthought.

Duke Energy sent statements to our homes each year enumerating the pension benefits that we would receive if we would stay with the company. The statements had a twofold purpose. First, they were to entice us to stay with the company. Second, they were an attempt to get us not to focus too much on our salary. The pension benefits were touted as being part of our "total benefits package." The implication was that we might not be drawing the best salaries, but if we stuck with the company, we would enjoy a reasonable early retirement benefit and retirement health insurance. We also had to work for ten years to become vested in the pension plan. I feel that we have earned our promised pension benefits because we have lived up to our end of the agreement. The company was in no financial difficulty when the conversion was announced. The conversion was based solely on greed. A few months after the conversion, Pan Energy was purchased. With the prospects of the pension plan now being a profit generator, grand earning promises were made to investors. The CEO laments about not being able to keep his promise to investors. He has zero concern for broken promises to employees. Senior management received a "supplemental credit" to their cash balance plans. The CEO received over a third of a million dollars as a supplemental credit to his cash balance plan. Employees lost up to fifty percent of the plan value with the opening balance! One employee had a retirement savings plan balance of $1,669.00 His initial cash balance amount was $84.00 (Yes, that's eighty-four dollars.) The people on an HR video were laughing about this. Many employees are not laughing.

Although companies will go to great lengths to convince employees that all cash balance plans are different and really cannot be compared, it is obvious that the opposite is true. Most cash balance conversions have certain common characteristics:

1. The employees generally lose benefits.
2. The employer generally gains a source of added revenue (the pension fund).
3. Early retirement benefits are lost.
4. Plan information is sketchy. Information provided is often very misleading.
5. Senior management frequently enjoy perks to nullify the conversion impact on their accounts.
6. The same dubious platitudes are cited as the reasons for the conversion.
7. Employers usually break their word to the employees. Decades old promises are trampled through the use of shaky technicalities.

It is a moot point that cash balance plans do not necessarily have to be designed to deprive employees of their pension funds. Let's stick with how they are actually implemented. The conversions seem very similar, other than a few cosmetic differences. Does anyone really believe that so many conversions have had virtually the same impact on employees by accident? There is obviously a concerted effort to deprive American workers of the pension benefits that they have earned and have been promised for decades. It is equally obvious who profits from most conversions. The employer profits greatly when a former liability becomes an asset. The actuarial firms promoting these conversions profit from implementing them. It is a win/win situation, except for the employees. The employees are looked upon as sheep to be sheered. The only crime the employees have committed is trusting the employers to keep their word. The employees of some companies that have suffered no negative conversion consequences were generally represented by strong labor unions. The sad fact is that without a strong union negotiating for employees, companies generally cannot be trusted to do the right thing.

The money paid into the pension funds was placed there for one purpose – to provide for the employees retirement. The companies have already enjoyed tax benefits for the amounts contributed to the funds. History has shown that there are those, employers included, who simply cannot allow a pension fund to serve its intended purpose. There are those who will scheme night and day for a method to crack into these funds. Private pension funds and Social Security suffer the fate of being under eternal attack. All manner of unscrupulous methods have been used in the past to rob employees of their earned pensions. Each time Congress has had to strengthen the laws protecting pensions. The connivers always go back to the drawing board and come up with a new pension attack. The cash balance plan is only the latest attempt to separate employees from their earned pensions.

Great insight into the cash balance matter is offered by "The Wall Street Journal's" article "How A Single Sentence By The IRS Paved The Way To Cash-Balance Plans." This article points out that in addition to actuarial firms and employers, at least one former government employee is responsible for the present day pension degradation.

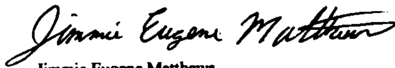
The Equal Employment Opportunity Commission is investigating the age discrimination aspect of cash balance plans now. The Department of Labor is investigating the aggressive tactics certain actuarial firms used in promoting cash balance plans. I know of no one who is expecting a prompt resolution. Perhaps it is time for Congress to take action, as has been necessary in the past, to protect pensions. Employees have a right to reasonably expect to receive the pensions that have been promised to them. They should not have to wake up each morning and wonder what has changed overnight – what have they lost today. They should not live from day to day not know what loophole or obscure technicality will be used against them to further reduce their retirement expectations. The pension issue in America has reached such a sorry state, that it may literally take an act of Congress to resolve the matter. A possible solution is to allow a choice of plans to all employees at retirement. IBM has forced employees to make the decision now – not at retirement age. This is not the way to offer choice.

Any mention of compromise does not set well with me. Employees are innocent victims in this matter. There should be no compromise in getting their earned benefits restored. Even if all the pension losses employees have suffered were restored, that would cover only part of the benefit reductions. Many

employers, along with cash balance conversions, have eliminated retirement health insurance coverage. Another long term promise has evaporated overnight.

It is noteworthy that an actuarial firm was going to force a cash balance plan on its employees. Being actuaries, these employees knew that the plan was not in their best interest. They protested so much that the matter was dropped. What does that tell you about cash balance plans. If the plans are so great for us, why will actuaries not touch one with a ten foot pole when it comes to their pension?

Regards,



Jimmie Eugene Matthews

Enclosure: "How A Single Sentence By The IRS Paved The Way To Cash-Balance Plans."

Pension Paternity: How a Single Sentence By IRS Paved the Way To Cash-Balance Plans — Age Bias Was No Concern,

The Wall Street Journal via Dow Jones

In August 1991, the Internal Revenue Service issued a long-awaited set of proposed pension regulations. In it was a single sentence, not present in a draft copy just 11 days before, that seemed to protect companies that were changing their pension plans to an ingenious new system.
"I sleep better at night" knowing the sentence is there, said an attorney with benefits consultants William M. Mercer at a conference for actuaries the following March.

And so, apparently, did clients. In the eight years since, hundreds of companies have converted their conventional pensions to "cash balance plans," which save them money by reducing the pensions accrued by older workers. Specifically, the sentence said that the new kind of pension didn't violate age-discrimination laws.

Employers are sleeping less soundly these days. In 1999, as millions of older workers realized exactly how cash-balance pensions work, they complained loudly enough that four federal agencies and Congress began looking into whether the plans do, in fact, illegally discriminate. Besides the IRS, the agencies are the Equal Employment Opportunity Commission, the Labor Department and the General Accounting Office.

While few Americans pay much heed to how pension law is developed, the story of the 49-word sentence and its paternity is pertinent to the lives of millions of baby boomers as they move closer to retirement. A review of government documents shows that the promoters of cash-balance pensions had some early fans at the Treasury Department. Among them was Richard Shea, then the associate benefits tax counsel, who became convinced early on that this new form of pension was a good idea and urged others at Treasury and the IRS to include the "safe harbor" sentence.

A month after The Sentence made its appearance, Mr. Shea left government to join Covington & Burling, a law firm that advised many large employers on pension matters and that later helped corporate clients such as Eastman Kodak Co. and International Business Machines Corp. with their pension plans.
The big difference between old-fashioned pensions and cash-balance ones is how benefits accrue. Under the old method, benefits build up mainly in one's later years on the job, when pay is usually highest. Under a cash-balance plan, the accrual of benefits is fairly flat throughout a career, growing through an annual contribution and interest credit to each

employee's account, or "cash balance."

In Mr. Shea's view, the old-fashioned pension system is flawed in that it provides lucrative benefits to only a few employees. "I firmly believe cash-balance plans provide a far better benefit to the vast majority of the work force," Mr. Shea says. Should the current flap over the plans deter employers from converting to them, he warns, the losers will be the vast numbers of workers who don't stick around long enough to benefit fully from traditional pensions, including many employees who are lower-paid and female.
Not since some companies and corporate raiders killed off pension plans for their assets during the leveraged-buyout era of the 1980s has there been so much focus by government on pensions. And not coincidentally, the roots of the current controversy lie in the 1980s.

Back in 1981, Kwasha Lipton, a benefits-consulting firm in Fort Lee, N.J., helped Great Atlantic & Pacific Tea Co. implement one of the first big pension-plan terminations. This triggered a wave of terminations, as some companies with overfunded plans pulled the plug on them to pluck out surplus assets. Congress soon began drafting legislation to stop this practice.
But even as it did so, Kwasha Lipton was developing a still-more-innovative way for companies to tap surplus pension assets: By converting their pensions to a cash-balance type, they could immediately reduce retirement obligations and put the surplus to work, without terminating the pension plan. The conversion rendered the plans even more overfunded than before, and the surplus could be used to pay various benefits costs that the company would otherwise have to pay some other way.

Kwasha Lipton -- now the Kwasha HR Solutions unit of PricewaterhouseCoopers -- began promoting the advantages of cash-balance conversions to employers. At a benefits conference in 1984, a partner at the firm stated that converting will, in general, "immediately reduce pension costs about 25% to 40%."
A 1986 report by Kwasha Lipton for clients said that cash-balance plans were good for, among other corporations, "companies seeking to reduce or modify" their pension costs and "companies considering termination of a pension plan in order to recapture overfunded assets." It noted that a cash-balance plan reduced the potential for negative employee reaction, compared with a pension termination, because employees still had a pension plan. Kwasha HR Solutions' chief actuary, Lawrence Sher, says that "in almost all cases, retirement program cost reduction is not a primary motive for making the plan changes."

He adds that the partner who said converting could cut pension costs also advised the companies that they could, if they chose, pass these savings on to employees. "I believe that the availability of the cash-balance design has resulted in fewer plan terminations, and that should be viewed as good for employees and the economy," Mr. Sher says.

The first cash-balance plan Kwasha Lipton devised was for Bank of America. At the time, 1985, the bank was in financial straits because of soured Latin American loans. Converting to a cash-balance plan immediately reduced its future pension liabilities, which saved it $75 million in the first year following the change, Bank of America's senior vice president of

compensation and benefits told employers at a 1993 Conference Board meeting.

The savings unlocked by this step, while substantial, resulted from arcane pension accounting and weren't readily detectable by nonspecialists, including most investors and regulators. Neither were the effects on many older employees. The pension switch drew no flak from either employees or regulators. Bank of America, since merged with NationsBank, declines to comment.

Initially, other consulting firms were skeptical of this radical design. But as Kwasha Lipton converted more pension plans, including those of Hershey Corp., Dana Corp. and Cabot Corp., other consultants got aboard. Soon, Mercer, Towers Perrin and Watson Wyatt developed their own versions of cash-balance plans.

Employers' interest in them surged in 1991 after the federal government slammed the door on the practice of killing pension plans for their assets. Congress enacted a steep excise tax on such assets.

The problem for employers was that the plans appeared likely to be in violation of age-discrimination law, which forbids reducing the rate of pension-benefits accrual as a person ages. Cash-balance plans have that effect – despite a more-or-less level annual rate of company contribution – because contributions in the later years have so much shorter a time to grow by investment.

But many professionals working on the plans figured they could convince the IRS that the age-bias-in-pensions law didn't apply to cash-balance plans. Their reasoning: The novel plans were intended to mimic savings plans such as 401(k)s, which aren't subject to rules on pension accrual.

Others fretted. Hugh Forcier, a lawyer at the firm of Faegre & Benson, warned in an October 1990 memo to practitioners at consulting firms that he didn't think the IRS would agree – nor that they could achieve "a legislative fix." He feared that cash-balance plans would be found to violate the law and that the subsequent costs to employers could be "truly staggering."

To make their case, benefits consultants and lawyers formed a sort of cash-balance practitioners' lunch and slide-show brigade for officials at the IRS, the Treasury, the Pension Benefit Guaranty Corp. and Capitol Hill.

The IRS had been skeptical for quite a while. In 1988 it told field offices to send in a copy of every cash-balance plan in existence – then fewer than 50 – so agency officials could dissect them. As a result of this review, some key IRS personnel publicly stated that they believed the plans violated age-discrimination law.

The consultants, however, found a receptive ear in Treasury officials such as Mr. Shea. Kwasha Lipton's Mr. Sher wrote to Mr. Shea in February 1991: "Since you are considering providing some guidance on cash-balance plans in the final nondiscrimination regulation package, including the possibility of a safe harbor, a meeting in the very near future would seem to be timely." Such meetings are routine between practitioners and government officials when regulations are being developed, and there is nothing improper about them.

Many meetings did take place between pension-plan practitioners and officials of the

Treasury and IRS. And while a core IRS group remained skeptical, and blocked a stronger statement that practitioners and some at the Treasury sought, the IRS people compromised. They allowed a "safe harbor" sentence to be inserted in the proposed regulations' final draft -- but it went into the preamble, where it would have less weight.

Specifically, the sentence stated that a pension plan's accrual features "will not cause a cash balance plan to fail to satisfy the requirement of section 411(b)(1)(H)." In other words, even though the rate at which benefits build up in cash-balance plans declines with age, employers don't have to worry that they are violating age-discrimination law.

A congressional staffer who was developing additional age-discrimination legislation at the time recalls being livid at the sudden appearance of the sentence. The EEOC wasn't consulted either, a top official there says.

The day after the proposed regulations were published, on Sept. 12, 1991, Mr. Shea told members of the Erisa Industry Committee, an employer group, that the proposals "provide a clear road map" for companies seeking to establish or change to a cash-balance system. It was his last public appearance as a Treasury official. Later that month, he joined Covington & Burling.

As the years passed, the IRS never took the next step and converted into a final regulation the sentiment expressed in the sentence about cash-balance plans and age bias. But more and more companies adopted cash-balance plans, taking comfort in the sentence, and the IRS continued to grant them tax-exempt status.

Then in 1999, following several articles in The Wall Street Journal, older employees at several companies discovered that they fared less well under the cash-balance plans. Some complained to members of Congress, and a number of bills have been introduced to address perceived abuses. Other employees protested to their employers, such as IBM, which, after converting its plan in July, backtracked in September and allowed an additional 35,000 older employees to stay in its old pension program.

Here, Mr. Shea re-enters the picture. Along with Kwasha Lipton's Mr. Sher, he has made numerous appearances on the Hill, becoming one of the most visible and ardent defenders of cash-balance plans in Washington. Mr. Shea has appeared on numerous panels at legal, actuarial and benefits conferences, provided testimony before the Erisa Advisory Council and spoken to women's pension groups and at the White House, plugging cash-balance plans' good points and strongly maintaining that they don't violate age-bias law.

His firm, Covington & Burling, has written articles for the Erisa Industry Committee to distribute in Congress and to the media, countering criticism of cash-balance plans. The law firm, besides defending clients in age-discrimination and pension suits, is helping clients squelch nascent litigation brought by employees who contend the new-style plans discriminate against aging workers.

In October, Covington & Burling began representing Onan Corp., a Cummins Engine Co. subsidiary that is the subject of a civil suit in federal court in Indianapolis alleging age bias in

its cash-balance plan. The law firm also is helping Onan defend a Tax Court case brought by workers seeking elimination of the cash-balance plan's tax-favored status.

The case has brought an unexpected twist to the cash-balance debate: The IRS said it agreed that Onan's pension plan should be disqualified.
This prompted Onan's lawyers to ask the court to disregard the IRS's opinion, on the ground that the tax agency hadn't thought the issues through. Onan's statement came in a motion for summary judgment that called the employee suit an "all-out assault on cash balance plans" and said the plaintiffs "seem determined to destroy cash balance plans."

IRS officials, in urging the Tax Court to move forward with the suit, said that "the issues involved in this case are ripe for decision." In other words, the IRS is challenging Onan's attorneys, including Covington & Burling, to prove the case for cash-balance pension plans.

As IRS officials revisit cash-balance plans, an issue they face is whether to insist that all plans comply with age-bias law -- or whether to endorse the 1991 sentence saying they are safe from this law. "We'll feel very put out if they don't agree after nine years," says Mr. Forcier, the Faegre & Benson lawyer who warned early on that the IRS might not agree with employers. He adds that cash-balance plans were all installed "in perfectly good faith, and the IRS never followed through with regulations."

Should the IRS come down hard on cash-balance plans, employers hold out hope that Congress will take action to change the law to ensure that cash-balance plans are legal.

Supporting their optimism is a historical parallel, involving insurance companies that manage pension money. In a dispute that reached the Supreme Court, the insurers argued that for 20 years, they relied on a sentence in a Labor Department bulletin that seemed to exempt them from fiduciary requirements under pension law. In 1993, the Supreme Court said, essentially, tough luck -- the sentence didn't have the force of law. Insurers and employer groups then sought a legislative rescue, and Congress provided one. It in effect overturned the high-court decision and insulated pension sponsors retroactively from employee lawsuits.

Whether Congress would do that for cash-balance plans, a considerably higher-profile issue, is anybody's guess.

June 13, 2000

The Honorable Chuck Grassley
Senate Special Committee on Aging
631 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Grassley:

I would like to add my testimony to the recent hearing held on June 5, 2000 regarding cash balance pension plans. I work for AT&T which converted from a traditional pension plan to one of a cash balance design in 1997. At the time of conversion, we were given brochures and other documentation regarding the wonderful benefits of cash balance pensions. We were also told our pension benefits were increased due to a one time special update. What we weren't told was that our future accrual of pension benefits had been sharply reduced by as much as 50%. To this day AT&T continues to supply misinformation about the negative affects of cash balance on employees. Also we were not given any option about staying in the old pension plan.

From my viewpoint the only advantages I see with AT&T's cash balance plan are portability and payment options. Under the old AT&T pension plan, if you left the company before being retirement eligible, you received a deferred vested pension at age 65 payable only by a monthly annuity. Under AT&T's cash balance pension plan, one has a number of payment options, including lump sum, monthly annuity, lump sum plus monthly annuity. The only down side of the payment options is an AT&T restriction on the lump sum payout, i.e., if one's cash balance is more than $30,000 more than your highest one year salary, you can only receive one year's salary as a lump sum, the balance must be taken as a monthly annuity which is taxable.

The two biggest problems I see with cash balance pensions are lack of disclosure and wearaway. Many companies, including AT&T, haven't fully disclosed the true affects of cash balance conversions to their employees because current law doesn't require it. ERISA 204(h) simply requires the companies to notify participants 15 days prior to any pension plan amendment that causes a significant reduction in future benefit accruals at age 65. The law only requires companies to summarize the changes and does not require companies to tell participants how these changes affect a participant's pension. It also does not require any notice that early retirement subsidies have been eliminated. This is wrong!

Companies should be required to fully disclose not only the pension plan changes but the affects of those pension plan changes on the participants. Plan participants need to have a comparison between the old pension plan and the new cash balance plan. In various articles written by employer benefit groups, such as ERIC and APPWP, these people claim it would place undue burden on the employer and pension plan administrator. This is incorrect. The employer and/or pension plan administrator are in the best position to make these comparisons as they have all the plan details as well as salary history and employee demographics. Social security is able to project my benefits at various ages, why can't my employer do this? Computers make solving the comparison problem trivial. The big benefit consulting firms like Watson Wyatt, Towers Perrin, etc. have the necessary software tools to make these comparisons also.

AT&T has told employees different things at various times about pension plan comparisons. Initially when employees raised questions, they were told you can't compare the old pension plan with the new pension plan because AT&T wouldn't haven't continued the old plan anyway. On another occasion an officer of the company said you can't compare the two because the old plan has been discontinued. And finally the company distributed a modeling tool that compared the cash balance plan with a hypothetical plan that was never even implemented. The fact is companies don't want employees to be able to compare plans since any comparison is going to be unfavorable to cash balance plans and they want to hide the fact that cash balance plans are really pension benefit reductions.

With AT&T's cash balance conversion, just about all of the older, long term employees were stuck with long wearaway's of anywhere from 7-10 years. I am puzzled when benefit consulting companies like Towers Perrin or Watson Wyatt say there is nothing wrong with wearaways and then proceed to go to into lengthy explanations and cite arcane laws that seem to support their reasoning. Evidently none of these consultants or actuaries have been on the receiving end of a cash balance conversion. It seems counter-intuitive to me that you have a given benefit under a traditional pension plan and then during a conversion to cash balance, that benefit is reduced. The pension consultants say these opening cash balances are not takeaways since current law gives a participant the greater of the old benefit or new cash balance. The pension consultants also state that wearaways are not age discriminatory since the length of the wearway is dependent upon length of service and salary history. Since employees with longer years of service are affected the most, this implies these people are older and means that wearaways are subtle forms of age discrimination. The problem is, current law gives the employers too much flexibility in setting opening cash balances. These laws need to be changed so that the opening cash balance is equal to the old benefit.

The pension industry also states that cash balance conversions encourage employees to work longer, this is not correct as many employees who have long wearaways due to cash balance conversions will move on. A couple of articles I've read support this:

Companies in mature industries, with an older work force may benefit the most from switching to cash-balance plans. By switching to a cash balance plan companies significantly reduce their current pension expense, and reduce the incentive for older workers to stay on the job since later years no longer balloon pension benefits.

http://www.dickinson.edu/~gallaghm/cashbalancepension.htm

Dickinson On-line Confidant
Dickinson College

This anomaly explains why a growing number of companies--among them AT&T, Empire Blue Cross Blue Shield, and Owens Corning--have dumped the traditional pension plan in favor of a so-called cash-balance plan that neither rewards long-timers nor penalizes job hoppers. Rather than have a pension based on length of service, most cash-balance plans grant everyone the same annual credit (between 4% and 8% of salary) plus interest toward an eventual pension, and if an employee leaves, he typically takes his "cash balance" with him. "These new plans pay people for what they're bringing to the firm today, not for what they brought to the firm yesterday," explains Ethan Kra, chief actuary at William M. Mercer. "Basically, they're designed to take away the incentive to stay a long time."

http://library.northernlight.com/SG19990714140000126.html?cb=13&sc=0#doc

Fortune

The pension industry would also have you believe that employers don't save any money by converting to cash balance, they are in fact skirting the truth. From Congressmen Bernie Sanders letter to the IRS:

In addition, current accounting rules actually encourage the practice of reducing pension benefits. Due to Financial Accounting Standard (FAS) 87, companies are able to report pension assets as operating income. By listing pension assets as operating income, companies can increase their bottom line by cutting the pension benefits of their workforce, which is exactly what is happening today.

http://www.house.gov/bernie/publications/letters/2000-02-24-pensions.html

This I believe is the real reason companies are converting their traditional pension plans to cash balance ones, by reducing pension liabilities through wearaways it allows them to pump up the bottom line:

Companies can also benefit from the way they invest the assets in the cash-balance accounts. If the employer promised to credit 5% interest to employees' account balances, it can keep whatever it earns above that amount. The company can use these earnings to finance other benefits, to pay for a work-force reduction, or -- crucially -- to cover future years' contributions. This is why the switch makes pension plans self-funding for many companies.

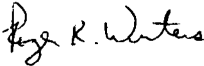
Although employers can do this with regular pensions, the savings are greater and easier to measure in cash-balance plans. The savings often transform an underfunded pension plan into one that is fully funded. "Cash-balance plans have a positive effect on a company's profitability," says Joseph Davi, a benefits consultant at Towers Perrin in Stamford, Conn. They "could be considered a profit center."

http://public.wsj.com/careers/resources/documents/19981204-schultz.htm

Wall Street Journal

I would like to thank you and the committee for your consideration. If you need additional information or clarification regarding my testimony, I can be reached at 407-327-0719 or at the address below.

Sincerely,



Roger K. Winters
654 Marlin Rd.
Winter Springs, FL 32708

65-919 2001 - 8

June 14, 2000
Senator Grassley and committee members

First I would like to thank you for the opportunity to express my thoughts concerning the cash-balance retirement plans. I am 48 years old and have worked for the same company, Eastman Chemical Company for 26 years. Our company changed our retirement plan from the traditional plan to a cash balance type plan in 1999. As a result of this change I will lóose approximately 30% or $120,000 when I retire.

Let me say that I am not opposed to cash balance plans as a retirement option. However, employers changing from a traditional retirement plan to the cash balance plan can take advantage of existing laws to reduce promised benefits to employees while increasing the profits of the company. I strongly believe that during the conversion from the traditional plan to the cash balance plan I was discriminated against because of my age.

During the testimony that has been presented to your committee on June 5, Mr. John Woyke makes the argument that these plans do not discriminate. However, even he states in his testimony *"If they seek to replace a traditional final pay plan with a cash balance plan, in most cases they provide transition benefits for mid-career and older employees who are most affected."* He has admitted that this conversion affects one group of workers more than another, therefore I believe this is discrimination.

Anyone looking at this issue has to ask the question of why is this occurring. This has been a topic of discussion at our company since the announcement of the change. At first the rumor was the retirement benefit account was almost broke. However, when the retirement account financial report was issued our account contained almost 1 billion dollars, and expenditures were less than contributions.

Finally I think we have the answer to this question. In an article written by Gretchen Morgenson for the New York Times titled "What's Hiding in Big Blue's Small Print" the author points out the IBM's financial statement shows an increase of approximately 30% in operating income for 1999. Author Morgenson states that approximately 1/3 or $267,000,000 of this increase in operating income comes for the pension fund. Increased profits equal huge bonuses for executive team members. For example employees in our work group received a bonus of approximately $200, while some members of the executive team received 1999 bonuses of over $700,000 therein lies the answer to the question of why convert!

What should be done about this? I do not believe that Congress should eliminate the cash balance plan option as a retirement benefit. However, I do believe that something should be done to level the playing field. If not, I strongly believe that our court systems will be flooded with discrimination suits against those companies that do not allow older workers the choice of staying with the traditional plan that was promised whey they were hired or the cash balance plan. Some companies have had the decency to do this, unfortunately many companies (including Eastman Chemical Company) have not provided this option.

I don't think this statement is speculation, in a recent public meeting the Chairwoman for the EEOC stated that as of April, 2000 5% of the EEOC's case load involved complains concerning cash balance retirement plans.

What should be done? I think that Congress should require two things of companies electing to change from traditional retirement plans to the cash balance plan:

1. The conversion from the traditional plan to the cash balance plan should be done fairly, the conversion should include any early retirement benefits and no wear-away allowed.

2. Older workers who have vested rights should be allowed to choose between staying with the promised traditional plan or choosing the cash balance plan.

I think that Congress should tax any company that does not conform to this practice a 50% tax on profits realized during the conversion from traditional to cash balance plans. I strongly believe that this would force companies to offer these choices and ensure that conversions are fairly done. I also think that by doing these things some fairness will be restored and it will reduce the burden on the EEOC and the court system.

Is this suggestion totally fair, no some employees who have vested rights and are not over 40 will lose, however, in some cases these employees can make up the difference or at least explore other job offers, something older workers can not do.

Thank you for your time and I appreciate the effort your committee is putting into this controversial issue.

Sincerely

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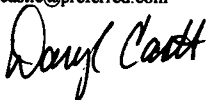

June 15, 2000

The Honorable Chuck Grassley
Senate Special Committee on Aging
631 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Grassley:

I would like to add my testimony to your recent Senate Special Committee on Aging hybrid plan hearing held on June 5, 2000. I recently retired from IBM (January 2000) at my earliest retirement eligible date (age 55 with almost 23 years of service) as what is typically referred to as an IBM 1st Choice employee (2nd Choice was those that added to pension choice, but not medical choice, on September 17, 1999). My husband, Thomas J. French, is still an active IBM employee, age 50, and a 2nd Choice employee. Due to both of us working at IBM and my husband did not get his lifetime medical restored and he has to last until 2004 without being surplus-ed or booted to qualify for the old plan retirement (will have 30 years service in 2004), we felt there was no CHOICE really for me to continue working past January 2000 and chance losing any more benefits and to try to ensure some real retirement medical for both of us under my 1st Choice retirement plan (since even if my husband lasts to 2004 for a pension, he did not get his retirement medical restored and the replacement FHA cash lump account is a pathetic replacement for lifetime medical that only the 1st Choice employees still have).

One of my primary complaints even as a 1st Choice employee is that IBM does not provide 'relative compare' data even when you have a choice. At retirement I had an option to take partial lump plus pittance annuity or 100% annuity [which in my case is actuarially 50% higher value, but that is not relayed to me by my employer at all]. They do not provide employees relative value comparison at all, likely hoping employees will select the partial lump plus pittance annuity because they have not been provided the relative comparison of the actuarial value between the two options. I had to engage experts to help me calculate both my original choice back in 1999 of c-b v old plan lifetime annuity and again when I retired in 2000 to help me with the value comparison of the lump+annuity or 100% annuity options under old plan retirement. This is totally unacceptable when employers have this data already. The majority of US employees will not know how to engage the proper experts to figure it out for them. Individual employees are at a severe disadvantage when it comes to engaging experts to help calculate the actuarial 'relative value compare' even when an employee is provided a CHOICE. Most Financial Analysts are not trained pension experts. In fact, most are paid on commission basis and would much prefer a customer take a cash lump and let them invest it for them, regardless of actuarial analysis of value. Most actuaries are already engaged by corporations and cannot service an individual due to conflict of interest. Even if one can find an expert pension actuary that does not have a conflict of interest with industry, they simply cannot afford the minimum of $200-400/per hour rates. So, I strongly object to the statements made during the June 5th hearing testimonies

about employers stating they simply cannot provide the REAL "Relative Compare" information to employees. Inexcusable! Many employees even that have a choice are being robbed because they don't have the real actuarial value comparison provided to them by the employer. Of course, the employers don't want employees to know that the lumps being offered are 30-50% of greater lower than the actuarial value of the lifetime annuities under the old plans. Employers don't even bother to tell you that part of this reduction difference is that any provisions of the old plan not insured by the PWBC such as the 'early retirement' subsidies are totally disregarded when they calculate your cash lump value.

Even after engaging an expert to assist me and my husband with our Choice options back in 1999, the hired actuary had problems calculating with the vague plan documentation provided to us. After I acquired a copy of the Form 5500 and additional documents from HR, the actuary finally got the calculations correct. It took me weeks to beg and acquire the information I needed from IBM HR to allow the actuary to assist us with the calculations and actuarial value compares.

Now even at retirement, IBM only provides me estimates of my retirement (not actuals) with no promise or indication of percentage of accuracy of these estimates. I had to make a lifetime decision based upon estimates and reportedly will not know the real retirement calculations for almost a year later. Again, this is totally inexcusable.

In fact, I don't know any employee who actually knows "WHO IS THE PLAN ADMINISTRATOR?". You write letters to the Plan Administrator and get a variety of inconsistent answers from different HR representatives that further cloud the issue and prevent and/or delay employees being able to make informed lifetime decisions.

I feel strongly that many actuaries and industry-supported consultants and lobbying groups such as ERIC and APPWP do not fulfill their fiduciary responsibility to correctly inform and represent the plan participants – the employees. They are much too concerned with getting their fees and donations from the industry and saving companies big money while robbing the earned and due benefits of the plan participants. They tend to MASK benefit reductions as much as possible, rather than DISCLOSE the minimal data that should be provided. Employees should not be reduced in benefits that they have already earned. Surplus should be used to enhance the employee benefits and provide retirees with COLAs rather than be used to prop the bottom line of corporations with vapor profits. A car doesn't run long on vapors and neither will these corporations.
I fear if the government does not step in and enforce the regulations already in-place that our country is headed for an economic disaster. Why? So, the CEOs and execs can enhance their own personal compensation and retirement benefits at the expense of their dedicated employees and investors.

I wish to thank you for your attempt at reviewing and discussing this issue at your June 5th Hearing. However, I was quite disappointed that only one other member of your committee was in attendance and the Panel 2 representatives (my opinion) made many statements that simply were incorrect. There did not appear to be many invited or in

attendance that had the knowledge and ability to even ask the Panel 2 presenters the right questions to bring the real truth to light. I hope you will have better quantity and quality of attendees on your future attempts to resolve these issues. There was an obvious missing presence at the June 5th hearing to really get the real facts and problems properly placed on the table for meaningful discussion and analysis and greatly needed ACTION.

Sincerely,

Lynda P French

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Please visit to review real facts on c-b & other hybrid plans

Age Discrimination in Cash Balance Plans: Another View

by Richard C. Shea, Michael J. Francese & Robert S. Newman[1]

Professor Zelinsky's article represents a substantial contribution to a growing body of academic literature on cash balance and other hybrid defined benefit plans.[2] This literature, along with other informed discussion of cash balance plans, is more important to our nation than it realizes. The outcome of the current cash balance debate will determine whether several trillion dollars in assets held in the nation's defined benefit plans can only be used to provide retirement benefits that conform to traditional plan designs. Such an outcome would be tragic for our country: In most segments of the economy, traditional defined benefit plans heavily skew benefits toward higher-paid, long-service employees, provide little or no benefit to 90 percent of the employees nominally covered by them, are a leading cause of inadequate retirement income among women, penalize older employees who want or need to work beyond early retirement age, expose younger and mid-career employees to unnecessary risk because of their heavily backloaded benefit accruals, and artificially constrain labor mobility.[3] Cash balance plans redress most if not all of these shortcomings.

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[1]Mr. Shea is a partner and Messrs. Francese and Newman are associates with the law firm of Covington & Burling in Washington, DC, where they concentrate in employee benefits and executive compensation. Prior to joining Covington & Burling in 1991, Mr. Shea served as Associate Benefits Tax Counsel of the United States Department of the Treasury. Mr. Shea is a 1976 graduate of Amherst College and a 1983 graduate of the University of Virginia School of Law, where he served as Executive Editor of the Virginia Law Review. Following his graduation from law school, Mr. Shea served as judicial clerk to the Hon. Carl McGowan of the United States Court of Appeals for the District of Columbia Circuit. Mr. Shea's experience with cash balance plans began during his service with the Treasury Department where, among other duties, he helped develop the safe harbor for cash balance plans in the regulations under Code § 401(a)(4). *See* Treas. Reg. § 1.401(a)(4)-8(c)(3). References in this article to the Code are to the Internal Revenue Code of 1986, as amended. Mr. Francese is a 1988 graduate of Duke University and a 1992 graduate of the George Washington University Law School, where he served as an editor of the George Washington University Law Review. Mr. Francese served as a judicial clerk to the Hon. Joyce Hens Green of the United States District Court for the District of Columbia before joining Covington & Burling in 1995. Mr. Newman is a 1992 graduate of Brown University and a 1996 graduate of the New York University School of Law. Mr. Newman served as a judicial clerk to the Hon. Alan Kay, Chief Judge of the United States District Court for the District of Hawaii, before joining Covington & Burling in 1999. In their current practice, the authors represent a number of clients that have implemented or are considering implementing cash balance or other hybrid defined benefit plans. Some of these clients currently are involved in litigation or administrative proceedings regarding their plans, including disputes over the age discrimination issues discussed in this article. The views expressed in this article are solely those of the authors and not necessarily those of their current or past clients, including Mr. Shea's former client the Treasury Department. No client, past or present, has reviewed this article or played any part in its preparation, monetary or otherwise. The authors take full responsibility for the views expressed herein.

[2]In addition to Professor Zelinsky's article, *see, e.g.*, Forman & Nixon, *Cash Balance Pension Plan Conversions*, ___ Oklahoma City U. L. Rev. __ (forthcoming).

[3]These shortcomings are well documented and stem from the interaction of two overarching facts: first, traditional defined benefit plans are heavily backloaded economically, providing meaningful retirement benefits only to long-service employees, *see, e.g.*, Forman, *Public Pensions: Choosing Between Defined Benefit and Defined Contribution Plans*, 1999 Det. C.L. Rev. 187, 196-98; and, second, only a small fraction of the workforce covered by traditional plans ever works for the sponsoring employer long enough to earn into these heavily backloaded retirement benefits, *see generally, e.g.*, Yacoboski, *Debunking the Retirement Policy Myth: Lifetime Jobs Never Existed for Most Workers*, EBRI Issue Brief (May 1998). As a result, the benefits provided by traditional plans typically are concentrated in the hands of relatively few employees who, because of their long service with the employer and other design features of traditional plans, also tend to be higher paid than most other employees. This phenomenon disproportionately affects women who, despite their changing role in the workforce, continue to experience greater job turnover during their working careers than men do. *See, e.g.*, Kopp, Joss & Sher, *A Benefit Value Comparison of a Cash Balance Plan with a Traditional Final Average Pay Defined Benefit Plan*, Society of Actuaries

Against this little understood backdrop, the charge is thrown up that cash balance plans discriminate against older employees. Informed critics readily admit that cash balance plans deliver equivalent benefits to all employees regardless of age, when measured in economic present value terms. The typical cash balance plan provides pay credits that are the same percentage of current compensation for all employees and interest credits on those pay credits that are the same for all employees as well. Cash balance plans that deviate from this norm do so by providing pay and interest credits that are, if anything, more generous to older workers. The criticism, however, is not that cash balance plans fail to deliver benefits of at least equivalent economic value to older employees. Rather, the charge is that they fail to replicate the pattern of benefit accruals under a traditional defined benefit plan. Because traditional plans provide benefit accruals that are heavily backloaded economically and cash balance plans do not, the basic age discrimination charge leveled against cash balance plans boils down to the simple observation that, when compared to traditional plans, cash balance plans increase the undersized benefit accruals employees receive earlier in their careers while simultaneously reducing the outsized benefit accruals they receive later in their careers.[4]

This somewhat technical and less compelling point captures both the central legal thesis of Professor Zelinsky's article and why he is so unenthusiastic about it as a matter of policy. Attention

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Monograph (1998). Because of the heavy backloading of benefit accruals in traditional plans, employees risk working many years for an employer in their early or mid-careers without accumulating adequate retirement benefits and subsequently losing out on the opportunity to earn into such benefits if their careers with the sponsoring employer are interrupted for any reason before retirement age. Traditional plans often impose additional economic penalties on employees who stop working before they reach certain ages. For example, in a traditional plan that provides subsidized early retirement benefits for long-service employees, the economic value of the employee's retirement benefit can easily double or even triple once the employee reaches early retirement age. *See, e.g., Hybrid Pension Plans: Hearings Before the Senate Comm. on Health, Educ., Labor & Pensions*, 106th Cong., 1st Sess. (Sept. 21, 1999) (statement of Ron Gebhardtsbauer, Senior Pension Fellow, Amer. Acad. of Actuaries) (hereinafter "Gebhardtsbauer"). As a result, employees who would otherwise qualify for early retirement benefits stand to suffer significant economic loss if they stop working for the employer before that age. Employees in this position often continue on in jobs they would otherwise leave simply to avoid the loss of early retirement subsidies. *See, e.g.*, Forman, *supra*, at 196. Just as the economic value of retirement benefits peaks at certain ages, it also declines after those ages. In many traditional plans, employees actually experience negative rates of benefit accrual in real economic terms if they continue working after they have qualified to begin receiving retirement benefits. In plans that include early retirement subsidies, that point typically comes just after the employee reaches early retirement age; in plans that do not include early retirement subsidies, the decline begins once the employee passes normal retirement age. In both cases, employees are penalized economically if they continue working once they reach the relevant age. *See, e.g.*, Forman, *supra*, at 198-200 & n.48; Gebhardtsbauer, *supra*, at 8; *see generally* Council for Economic Development, *New Opportunities for Older Workers*, at 24-25 (1999). Given the economic penalties imposed by most traditional plans on older employees who want or need to continue working beyond retirement age, it is curious that the charge of age discrimination is leveled at cash balance plans which contain no such penalties.

[4]As one critic has put it, the "disadvantage" of cash balance plans is that under them older workers "earn the same benefit" as younger workers. Ellen Schultz, *Problems with Pensions: What You Don't Know About the Cash-Balance Retirement Plans Can Hurt You*, Wall St. J., Nov. 8, 1999, Encore Special Report at 8. Although traditional defined benefit plans delay meaningful benefit accruals until late in an employee's career, once the point of maximum accrual is reached the economic value of the employee's accrued benefit typically begins to decline, resulting in a negative rate of benefit accrual from an economic perspective. *See supra* note 3.

no doubt will focus on his central thesis that, even outside the conversion context,[5] cash balance plans violate the current statutory rules against age discrimination in defined benefit plans. Readers would do well to pay equal attention to the policy concerns and legislative proposals Professor Zelinsky develops elsewhere in his article, which are far more favorable to cash balance plans. Be that as it may, our purpose here is to explain briefly why Professor Zelinsky's central thesis misinterprets current law.[6] For this purpose, we divide our analysis into two parts: first, an explanation of why the method Professor Zelinsky proposes for determining rates of benefit accrual turns the age discrimination statutes on their head and, second, an explanation of why, even if his method were correct, the declining rates of benefit accrual he observes are not "because of the attainment of any age" but, instead, because of the inflation protection automatically built into cash balance plans.

Determining Rates of Benefit [illegible]. The age discrimination statutes prohibit defined benefit plans from reducing the rate of an employee's benefit accrual on account of the attainment of any age.[7] Key to Professor Zelinsky's conclusion that cash balance plans violate current age discrimination laws is his insistence that rates of benefit accrual be expressed in the form of annuity benefits beginning at normal retirement age. Only then is he able to show that cash balance plans produce declining rates of benefit accrual as an employee approaches normal retirement age. Certainly the method he proposes for determining benefit accrual rates is not without precedent and commonly is used, as he quite properly points out, for purposes of applying the anti-backloading rules of Code section 411(b)(1)(A) through (C).[8] The truth of the matter, however, is that the term "rate of benefit accrual" is nowhere defined in the age discrimination statutes.[9] Moreover, benefit accrual rates are

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[5]The conversion context mentioned above in text refers to situations in which an employer takes a traditional defined benefit plan it has sponsored for many years and amends the plan to convert it from its prior traditional design to a new cash balance design.

[6]Due to limitations of time and space, it is not possible to comment on all aspects of Prof. Zelinsky's article or even to present here all of the reasons why his central thesis misinterprets current law. One point he makes apart from his central thesis, however, cannot be left unchallenged. In his article, Prof. Zelinsky concludes, based on a single hypothetical involving 2 employees, that most cash balance plans violate the age discrimination rules when they use the so-called "wear-away" method to transition from a previous traditional defined benefit plan design to the new cash balance plan design. He bases this conclusion on his observation that a 55-year-old employee in his hypothetical experiences a wear-away period, while a 35-year-old employee does not, even though both employees have 3 years of service and the same pay history. If Prof. Zelinsky were to examine employees with other combinations of age and service in his own hypothetical or in plans with more typical transition provisions, he would find that the correlation he observes disappears entirely. In fact, service and the size of an employee's accrued benefit under the prior traditional plan design are far more predictive of wear-away than age is. Furthermore, employees with the least wear-away often are in their 60's and 70's, contrary to what Prof. Zelinsky suggests.

[7]Code § 411(b)(1)(H)(i); ERISA § 204(b)(1)(H)(i); ADEA § 4(i)(1)(A). References in this article to ERISA are to the Employee Retirement Income Security Act of 1974, as amended, and references to ADEA are to the Age Discrimination in Employment Act of 1967, as amended. For convenience sake, references in text generally are limited to the applicable Code provisions and, except as necessary, references to any parallel provisions of ERISA and ADEA appear in the accompanying footnotes only.

[8]*See also* ERISA § 204(b)(1)(A)-(C).

[9]*See* Code § 411(b)(1)(H); ERISA § 204(b)(1)(H); ADEA § 4(i).

determined using a variety of different methods for different purposes under the Code and ERISA.[10] In light of the problems created by Professor Zelinsky's method (which we examine in greater detail below), it is surprising that he does not explore or even acknowledge these other methods.

A review of the various methods developed for determining benefit accrual rates under the Code and ERISA strongly suggests that the method chosen critically depends on the purpose for which it is being applied. This is only logical given that the point of developing a particular method is to implement the underlying statutory provision for which the method will be used. Indeed, it would be irresponsible to develop a method for determining benefit accrual rates without taking into account the purpose of the underlying statute. This is especially true where the statute itself is silent on the method to be applied and where a variety of different methods have been employed to implement different statutory provisions. The starting point for evaluating the appropriateness of Professor Zelinsky's method, then, is the statute itself.

Both the statute and the legislative history make clear that Congress enacted the current age discrimination rules for defined benefit plans to protect employees who continue to work after normal retirement age. Before enactment of the current rules in the Omnibus Budget Reconciliation Act of 1986 (the "1986 Age Act"),[11] defined benefit plans typically ceased benefit accruals for employees once they reached normal retirement age.[12] The 1986 Age Act was intended to prohibit this practice of eliminating or reducing benefit accruals after a specified age.[13] While the statute and legislative history are quite clear about how the rules apply after normal retirement age, their application before normal retirement age remains murky. Indeed, at one point the legislative history suggests that the

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[10]For example, for purposes of the nondiscrimination requirements of Code § 401(a)(4), accrual rates can be determined using any of a variety of different methods. *See* Treas. Reg. § 1.401(a)(4)-3(d) (providing multiple optional methods for determining accrual rates). These methods are different from those that apply for purposes of the anti-backloading rules of Code § 411(b)(1)(A)-(C) and the notice requirements of ERISA § 204(h). One fundamental difference is that accrual rates for purposes of the nondiscrimination requirements consider benefits accrued both before and after normal retirement age, *see* Treas. Reg. § 1.401(a)(4)-3(f)(3), whereas the anti-backloading rules and ERISA's notice requirement consider benefits accrued only through normal retirement age, *see* Code § 411(b)(1)(A)-(C); Treas. Reg. § 1.411(d)-6 Q&A-5(a)(1) (providing a definition of rate of accrual for purposes of ERISA § 204(h)). Another fundamental difference is that accrual rates for nondiscrimination purposes consider early retirement and other optional forms of benefit, *see* Treas. Reg. § 1.401(a)(4)-3(d)(1)(ii), whereas the anti-backloading rules and ERISA's notice requirement do not, *see* Code § 411(b)(1)(A)-(C); Treas. Reg. § 1.411(d)-6 Q&A-5(b). A final critical distinction discussed later in this article is that the nondiscrimination rules in certain circumstances permit benefit accrual rates to be expressed in terms of annuity benefits beginning at the employee's current age rather than at normal retirement age. *See* Treas. Reg. § 1.401(a)(4)-12 (paragraph (*4*) of definition of "testing age"). For additional methods of determining accrual rates, *see* Code § 416(g)(4)(F)(ii) (top heavy rules); Treas. Reg. § 1.401(a)-1(b)(1)(iii) (definitely determinable benefits); Treas. Reg. § 1.410(b)-5(d)(5) (average benefit percentage test); ERISA § 4022A(c)(3) (guarantee of benefits for multiemployer plans).

[11]Pub. L. No. 99-509, 100 Stat. 1874 (1986).

[12]H.R. Conf. Rep. No. 1012, 99th Cong., 2d. Sess. 375, 1986 U.S.C.C.A.N. 3868 (hereinafter referred to as the "Conference Report").

[13]*Id.* at 375 (present law), 376 (Senate amendment), 378 (Conference agreement).

rules are not intended to apply before normal retirement age at all.[14] However this uncertainty is resolved, one point is crystal clear: Congress intended the 1986 Age Act to govern the rate of benefit accrual after normal retirement age.

Given this purpose, the method Professor Zelinsky has proposed to determine benefit accrual rates seems particularly odd. He has borrowed a method for determining benefit accrual rates from the anti-backloading rules that, by their very terms, never apply after normal retirement age.[15] It is certainly awkward to evaluate benefit accruals after normal retirement age by converting them into benefit accruals at normal retirement age, *i.e.*, in a year before the benefit accruals have even been earned. More problematic, however, is the fact that, when applied to accruals after normal retirement age, Professor Zelinsky's method produces results that are the exact opposite of what Congress intended.

The legislative history provides an example of a defined benefit plan under which an employee earns an annuity benefit of $10 per month per year of service. This type of benefit, often referred to as a flat-dollar benefit, is typical of plans maintained for collectively bargained employees. Under the plan described in the legislative history, an employee who retires with 10 years of service at age 65 is entitled to receive an annuity of $100 per month beginning at age 65 (*i.e.*, $10 per month per year of service times the employee's 10 years of service). If the employee continues to work past age 65, he is entitled to $110 per month beginning at age 66, $120 per month beginning at age 67, and so on. Under the legislative history, the plan complies with the age discrimination rules because the employee's benefit accruals remain constant after age 65—each year, the employee accrues an additional $10 per month benefit.[16]

If Professor Zelinsky's method is applied to this example, the employee's additional benefit accruals would have to be converted to annuities payable beginning at age 65. Doing so causes the employee's rate of benefit accrual to appear to decline as the employee ages. The following chart il-

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[14] *Id.* at 379 ("Under the conference agreement, the rules preventing the reduction or cessation of benefit accruals on account of the attainment of age are not intended to apply in cases in which a plan satisfies the normal benefit accrual requirements [*i.e.*, the anti-backloading rules] for employees who have not attained normal retirement age." (bracketed language added)).

[15] The anti-backloading rules only apply to benefit accruals through normal retirement age and do not restrict benefit accruals after normal retirement age. *See* Treas. Reg. § 1.411(b)-1(b)(1)(i), (b)(2)(ii)(E), (b)(3)(ii)(C) (3-percent, 133⅓-percent, and fractional rule methods, respectively). As a result, plans can backload benefit accruals as much as they like after normal retirement age as long as the accruals satisfy the other requirements of the Code and ERISA, including, in particular, the nondiscrimination rules of Code § 401(a)(4). *See* Treas. Reg § 1.401(a)(4)-3(f)(3).

[16] Conference Report at 381. In proposed regulations, the IRS describes a similar plan that provides $20 per month for each year of service and concludes that the plan complies with the age discrimination rules as long as it provides an additional $20 per month for each year of service that an employee works past normal retirement age. *See* Prop. Treas. Reg. § 1.411(b)-2(b)(4)(iv), Ex. 1. Although both examples also discuss the suspension-of-benefits rules, the conclusion they reach for age discrimination purposes is the same regardless of the application of those rules.

lustrates the employee's benefit accruals from ages 65 to 70 calculated under Professor Zelinsky's method:[17]

Age	Additional Benefit Accrual Each Year	Additional Benefit Accrual Expressed as Annuity Payable at Age 65
65	$10.00	$10.00
66	$10.00	$8.90
67	$10.00	$7.90
68	$10.00	$7.00
69	$10.00	$6.10
70	$10.00	$5.41

This decline in the rate of benefit accrual after normal retirement age is not limited to plans with flat-dollar benefits. Most traditional defined benefit plans would appear discriminatory after normal retirement age under Professor Zelinsky's method, including most final and career average pay plans.[18] Indeed, the only defined benefit plans that would not fail Professor Zelinsky's test after normal retirement age are (ironically) cash balance plans and traditional plans that, like cash balance plans, actuarially adjust benefits for late commencement after normal retirement age.[19]

The fact is, applying Professor Zelinsky's method for determining benefit accrual rates to the accruals Congress cared most about—those after normal retirement age—causes plans that Congress clearly intended to pass the age discrimination rules to fail them. This result is not surprising given that the method Professor Zelinsky has proposed was never intended to apply to accruals after normal retirement age in the first place. To avoid these unintended results, it might be possible to limit application of Professor Zelinsky's method to accruals before normal retirement age. However, that approach would end up affording greater protection to employees before normal retirement age

[17]The actuarial conversions in the table are based on a discount rate of 8.75% and the 1983 Group Annuity Mortality Table (Unisex).

[18]Despite the results of applying Prof. Zelinsky's method to them, Congress clearly intended final and career average pay plans to satisfy the age discrimination rules if they provide employees with the same percentage of pay per year of service after normal retirement age as before. *See* Prop. Treas. Reg. § 1.411(b)-2(b)(1)(iii).

[19]Cash balance plans and traditional plans that actuarially adjust benefits for late commencement provide progressively larger annuity benefits at each succeeding age after normal retirement age. When these progressively larger annuity benefits are converted into annuities beginning at normal retirement age, the resulting annuities are level and therefore satisfy the age discrimination rules under Prof. Zelinsky's method. Although substantial variety still exists among various pension equity plan designs, it is likely that most pension equity plans would also satisfy the age discrimination rules under Prof. Zelinsky's method after normal retirement age for the same reason. Technically, traditional plans that actuarially adjust benefits for late commencement after normal retirement age might still be considered to provide declining rates of benefit accrual under Prof. Zelinsky's method since the right to the actuarial adjustments arguably accrues in the years before the adjustments are made, *i.e.*, for the most part, before normal retirement age. However, the statute appears to treat the adjustments as if they accrued in the years in which the adjustments are made, *i.e.*, entirely after normal retirement age. *See* Code § 411(b)(1)(H)(iii)(II); ERISA § 204(b)(1)(H)(iii)(II); ADEA § 4(i)(3)(B).

than after—the very harm Congress sought to eliminate when it enacted the current age discrimination rules in 1986. The only conclusion to be drawn is that, while Professor Zelinsky's method might be perfectly appropriate for applying the anti-backloading rules, it is the wrong method for applying the age discrimination rules—at any age.

Applying Professor Zelinsky's method to accruals before normal retirement age would also cause most contributory defined benefit plans to fail the age discrimination rules—a result Congress clearly did not intend. Under Code section 411(c), defined benefit plans that are funded with employee contributions are required to determine employees' accrued benefits in precisely the same manner as cash balance plans do. In a contributory defined benefit plan, every employee must accrue a credit each year equal to his or her mandatory contributions to the plan for the year (most often determined as a percentage of the employee's pay for the year), plus future statutory interest credits on those contributions.[20] These credits are directly analogous to the pay and interest credits in a cash balance plan and accrue in precisely the same pattern.[21] Thus, when the accruals under a contributory defined benefit plan are converted into annuities beginning at normal retirement age, the plan will appear to produce declining rates of benefit accrual at every age before (but not after) normal retirement age, in a pattern identical to that Professor Zelinsky observes for cash balance plans. Because contributory defined benefit plans are subject to the same age discrimination rules as other defined benefit plans, applying Professor Zelinsky's method before normal retirement age would cause most contributory defined benefit plans to fail the age discrimination rules merely because the plans are complying with the requirements Congress set out for them in Code section 411(c). Congress clearly did not intend this result, but it is an inevitable consequence of accepting Professor Zelinsky's method for determining benefit accrual rates before normal retirement age.

If Professor Zelinsky's method is the wrong method for applying the age discrimination rules, what then is the right method? The truth be told, it is unlikely Congress ever intended to apply a quantitative, computationally intensive method for determining benefit accrual rates in order to judge whether a defined benefit plan discriminates on the basis of age, as Professor Zelinsky and the critics of cash balance plans now propose. Rather, Congress probably intended what it said, namely, that defined benefit plans should no longer be able to specify an age after which an employee's benefit accruals will be reduced or eliminated.[22] Before Congress acted to ban this practice in 1986, tra-

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[20]Code § 411(c)(2)(B)-(C); ERISA § 204(c)(2)(B)-(C).

[21]The method for calculating benefit distributions under a contributory defined benefit plan is quite similar to the method used under a cash balance plan as well. Thus, if the employee receives his benefit from a contributory defined benefit plan in the form of a lump sum, the lump sum cannot be less than the sum of the employee's mandatory contributions for all years plus the statutory interest on those contributions through the date of distribution. Similarly, if the employee receives his benefit in the form of an annuity, the annuity cannot be less than the actuarial equivalent of the employee's accumulated contributions including statutory interest. *See* Code §§ 411(c)(2)(B)-(C) & (c)(3), 417(e); ERISA §§ 204(c)(2)(B)-(C) & (c)(3), 205(g).

[22]Conference Report at 378 ("Under the conference agreement, benefit accruals or continued allocations to an employee's account under either a defined benefit plan or a defined contribution plan may not be reduced or discontinued on the account of the attainment of a *specified* age." (emphasis added)).

ditional defined benefit plans routinely provided otherwise. Traditional plans, for example, typically stated that an employee was entitled to an accrued benefit equal to a fixed percentage of pay times years of service before age 65 and no benefit attributable to years of service after age 65. Implementing Congress' mandate to ban such practices requires no more than reading the plan document to make sure it contains no age-specific provisions like these that cut off or reduce an employee's benefit accruals after a specified age.

In addition to the plan language approach, however, there is a quantitative method that fulfills the purpose and goals of the age discrimination laws, and it is found in one of the multiple methods for calculating benefit accrual rates provided under the nondiscrimination rules of Code section 401(a)(4). In testing accruals after normal retirement age, the nondiscrimination rules permit plans to calculate benefit accrual rates in terms of immediate annuities beginning at the employee's current age rather than as annuities beginning at normal retirement age.[23] Applying this method produces results that coincide perfectly with the results Congress intended: Plans that Congress meant to fail the age discrimination rules do fail when tested using the immediate annuity method, and plans that Congress meant to pass the age discrimination rules pass when tested using the method.[24] A method that actually produces the result Congress intended has something to recommend it.

That said, is there any reason not to apply the immediate annuity method to accruals before normal retirement age?[25] Not really. Calculating immediate annuities is something most plans do already.[26] Applying the same method for determining benefit accrual rates before and after normal retirement age certainly avoids the problem of providing greater protection to employees before normal retirement age than after. And existing plans that Congress never intended to run afoul of the age dis-

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[23]Treas. Reg. § 1.401(a)(4)-12 (paragraph (4) of definition of "testing age"); *see also* Treas. Reg. §§ 1.401(a)(4)-12 (definition of "normalize"), 1.401(a)(4)-3(d)(2)(i) (general requirement of normalization at testing age), 1.410(a)(4)-3(f)(3) (testing of accruals after normal retirement age).

[24]Applying the immediate annuity method to the flat-dollar plan described in the legislative history illustrates this point. As discussed earlier, that plan provides an annuity benefit of $100 per month beginning at age 65 ($10 per month per year of service times 10 years of service), $110 beginning at age 66, $120 beginning at age 67, and so on. Expressing the rate of benefit accrual in terms of the increase in the immediate annuity beginning at the employee's current age in each succeeding year, the plan provides for a level increase of $10 per year in the employee's immediate annuity and therefore satisfies the age discrimination rules, as Congress intended. On the other hand, if the plan lowered the benefit accrual rate to $5 or $0 per month per year of service after age 65, the plan would produce a declining rate of benefit accrual from age 65 to 66 under the immediate annuity method and therefore would fail the age discrimination rules, again, as Congress intended.

[25]That is, any reason other than uncertainty that Congress intended the age discrimination rules to apply before normal retirement age at all. *See* supra note 14 and accompanying text.

[26]To the extent a plan does not define immediate annuities at all ages before normal retirement age, such annuities can be calculated using the actuarial assumptions stated in the plan or, alternatively, using standard actuarial assumptions applied to defined benefit plans for other purposes. *See, e.g.*, Code § 417(e)(3) (GATT assumptions); Treas. Reg. § 1.401(a)(4)-12 (definitions of "standard interest rate" and "standard mortality table"). Consistent with the age discrimination rules, immediate annuities would be calculated without regard to any early retirement subsidies under the plan. *See* Code § 411(b)(1)(H)(iv); ERISA § 204(b)(1)(H)(v); ADEA § 4(i)(6).

crimination rules, such as contributory defined benefit plans subject to Code section 411(c), satisfy the rules when tested using the immediate annuity method, even before normal retirement age.

Regardless of whether one adopts a plan language approach that focuses on express decreases in the benefit accruals provided under the plan at specified ages, or a quantitative approach that calculates rates of benefit accrual, or even a combination of these two approaches,[27] cash balance plans satisfy the age discrimination rules. Under the only quantitative approach that comports with Congressional intent (the immediate annuity method), cash balance plans produce gradually increasing rates of benefit accrual throughout an employee's career. Furthermore, as noted earlier, even under Professor Zelinsky's proposed method, cash balance plans produce level rates of benefit accrual after normal retirement age—*i.e.*, at the very ages Congress cared most about. It would be ironic if cash balance plans were found to fail age discrimination because of Professor Zelinsky's method, even though they satisfy that method after normal retirement age while most traditional plans do not.[28] Finally, under the plan language approach, there is no cash balance plan we are aware of that decreases the rate of pay or interest credits because an employee has attained a specified age. The majority of cash balance plans provide the same pay and interest credits to all employees; those cash balance plans that deviate from this norm provide pay and interest credits that are, if anything, more generous to older employees.

"Because of the Attainment of any Age." Even if Professor Zelinsky were right and cash balance plans did result in a decline in the rate of benefit accrual before normal retirement age, that decline would not violate the age discrimination rules because the decline is not "because of the attainment of any age."[29] On the contrary, the decline observed under Professor Zelinsky's method is solely attributable to the inflation protection automatically built into cash balance plans. This feature of cash balance plans helps prevent the purchasing power of employees' benefits from being eroded over time through increases in the cost of living. While inflation-protection features are measured over units of time just as age is, what they measure is quite distinct. Age measures the social and physiological changes of the human organism over time, while inflation-protection features measure changes in the purchasing power of currency over time.[30] For this reason, bona-fide inflation-protec-

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[27]Given the legislative history, it is hard to see how the textual approach can be ignored even if one concludes that a quantitative approach also is required.

[28]*See* supra notes 18-19 and accompanying text.

[29]*See* Code § 411(b)(1)(H)(i); ERISA § 204(b)(1)(H)(i); *see also* ADEA § 4(i)(1)(A) (using the phrase "because of age"); Conference Report at 378-79 ("The conferees intend that the provisions of ADEA, ERISA, and the Code that are amended to prevent the reduction or cessation of benefit accruals on account of the attainment of any age are to be interpreted in a consistent manner and do not intend any differences in language in the provisions to create an inference that a difference exists among such provisions.")

[30]Similarly, service measures the length of the employee's period of employment with the employer. Thus, service is recognized as distinct from age, even though both are measured in units of time. *See* Code § 411(b)(1)(H)(ii); ERISA § 204(b)(1)(H)(ii); ADEA § 4(i)(2). Distinctions among age, service, and inflation protection are also evident from the points in time at which they begin and cease to be measured. Age begins at birth and ends at death. Service begins at hire and ends

tion features are not and never have been considered age discriminatory. Quite the contrary, they are viewed as valuable safeguards that far too few employees enjoy in their retirement benefits.

The claim that cash balance plans produce declining rates of benefit accrual rests on the fact that most cash balance plans promise to continue interest credits to an employee's cash balance account even after the employee stops working for the employer and until the employee begins receiving benefits under the plan.[31] Because the right to receive interest credits is not contingent on the employee's continued employment with the employer, the interest credits the employee receives on each pay credit he or she earns under the plan are treated as accruing in the same year as the pay credit itself.[32] Thus, if the plan provides a pay credit each year equal to five percent of the employee's pay for the year and guarantees interest credits on that pay credit until benefit commencement, both the pay credit and the future interest credits on it are treated as having been accrued in the year the pay credit is earned. Under Professor Zelinsky's method of calculating benefit accrual rates, each pay credit and the future interest credits on it are projected forward to normal retirement age and converted into an annuity beginning at that age. Because the pay credit in each succeeding year has one year less of interest credits it can earn until normal retirement age, the analysis goes, the employee accrues a progressively smaller annuity benefit each year up to normal retirement age and hence experiences a declining rate of benefit accrual.

The inflation protection afforded by the guaranteed interest credits under a cash balance plan becomes apparent once the alternative is considered. Suppose a cash balance plan failed to guarantee future interest credits and instead made them contingent on an employee's continued service with the employer. Under this alternative, interest credits would not accrue in the year of the underlying pay credit but rather year by year as the employee continued to work. Besides creating compliance problems for the plan under the anti-backloading and nondiscrimination rules, the resulting pattern of benefit accruals would shift the corresponding annuity value of the interest credits later into the employee's career with the employer and would eliminate entirely the declining pattern of benefit accruals Professor Zelinsky observes under his method for determining benefit accrual rates. For employees who spend their entire careers with the employer and commence benefits immediately upon retirement, no change in benefits would result—because they continue to work for the employer until benefit commencement, these employees would experience no loss of interest credits. However, for employees who stop working for the employer earlier in their careers (as most inevitably will) and who wish to wait until their own retirement to begin receiving benefits, the result is far less favorable—because they stop working for the employer before benefit commencement, these

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at termination of employment. Inflation protection, in the case of pre-retirement protection, begins upon commencement of participation and ends either at termination of employment or commencement of benefits, and in the case of post-retirement protection, begins at commencement of benefits and ends upon termination of benefits.

[31]This means that interest credits also are continued if the employee, before terminating employment, ceases active participation in the plan either because he has been transferred into a position not covered by the plan or because the employer has frozen or terminated the plan.

[32]*See* IRS Notice 96-8, 1996-1 C.B. 359 (Feb. 5, 1996).

employees would cease to earn interest credits as soon as they leave their jobs with the employer and, without the intervening interest credits, the value of their retirement benefits under the plan would gradually be eroded through future increases in the cost of living. Thus, the critical difference between a cash balance plan that guarantees future interest credits and one that does not lies in the fact that the plan with guaranteed interest credits provides greater protection to employees as they grow older by ensuring that the value of their retirement benefits will not be eroded through inflation if they leave their job with their current employer.

Even though guaranteed interest credits cause a cash balance plan to produce declining rates of benefit accrual before normal retirement age under Professor Zelinsky's method, the plan should not fail the age discrimination rules because the guaranteed interest credits are a bona-fide inflation-protection feature and are not provided on account of the attainment of any age. At a trivial level, the typical cash balance plan continues to provide guaranteed interest credits even after an employee *dies* and until the employee's beneficiary begins receiving benefits, which in the case of the employee's surviving spouse could be many years in the future. If the employee does not even need to be alive for interest credits to continue to accumulate, they have not been provided because of the employee's attainment of any age.

At a more serious level, traditional defined benefit plans use a variety of mechanisms to adjust employees' benefits to make up for increases in the cost of living. No one, least of all Congress, has ever suggested that these mechanisms cause defined benefit plans to run afoul of the age discrimination rules. Many of these mechanisms operate indirectly. For example, final average pay plans index employees' benefits to increases in their pay. Similarly, career average pay plans often are updated to reflect current rather than historical levels of pay. And flat-dollar union pension plans typically are renegotiated at the beginning of most collective bargaining cycles to increase the flat-dollar amount employees earn per year of service. Like cash balance plans that condition interest credits on an employee's continued employment, traditional plans almost always halt these forms of indexing once the employee terminates employment.

There are other forms of inflation protection in traditional plans, however, that operate more directly and that do not end on termination of employment. The most obvious of these are post-retirement cost-of-living adjustments that are provided either automatically under the plan or on an ad-hoc basis by plan amendment.[33] In addition, career average pay plans occasionally provide pre-retirement cost-of-living adjustments that automatically index employees' annual pay by an interest factor or by changes in the consumer price index.[34] Similarly, as discussed earlier, contributory defined benefit plans are required under Code section 411(c) to index employees' mandatory plan contributions by a statutory interest factor. These latter two adjustments, provided respectively under indexed career average pay plans and contributory defined benefit plans, are directly analogous to

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[33] *See* Treas. Reg. § 1.410(b)-3(b).

[34] *See* Rev. Rul. 71-446, § 18.02, 1971-2 C.B. 187; Rev. Rul. 185, 1953-2 C.B. 202; Strella, *Specialized Qualified Plans–Cash Balance, Target, Age-Weighted & Hybrids*, 352-2d Tax Mgmt. (BNA) § V.A.2., at A-33.

the guaranteed interest credits in a cash balance plan and operate almost identically to them. Finally, the largest traditional defined benefit plan of all, the Social Security system, provides both pre- and post-retirement inflation adjustments by indexing Social Security old-age retirement benefits for increases in average national wages before retirement age and then for increases in the consumer price index thereafter.[35]

There is no question that, regardless of their form, inflation adjustments in defined benefit plans are more valuable the younger an employee is when he or she begins receiving them. This is true for the simple reason that an employee faces fewer years of future inflation as the employee grows older. Indeed, if one tests virtually any inflation adjustment under Professor Zelinsky's method for determining benefit accrual rates, a declining rate of benefit accrual will emerge, whether the adjustment applies pre-retirement or post-retirement, as long as the right to receive the adjustment accrues in a year before the adjustment is scheduled to be made.[36] The inflation adjustments that produce declining benefit accrual rates under Professor Zelinsky's method include all automatic post-retirement cost-of-living adjustments, pre-retirement pay adjustments in indexed career average pay plans, statutory interest credits in contributory defined benefit plans, and both the pre- and post-retirement inflation adjustments in Social Security old-age retirement benefits. Despite this fact, there is absolutely no evidence that Congress intended the age discrimination rules to outlaw inflation adjustments in defined benefit plans.

Consistent with this view, the Treasury and the IRS have explicitly approved the use of guaranteed interest credits in cash balance plans on at least two occasions.[37] In addition, in the preamble to the 1991 final regulations under Code section 401(a)(4), the agencies concluded that the use of guaranteed interest credits does not cause a cash balance plan to violate the age discrimination rules.[38] These conclusions undoubtedly reflect the agencies' perception that guaranteed interest credits not only help cash balance plans satisfy the anti-backloading and nondiscrimination rules, but also protect the value of employees' retirement benefits from erosion through inflation in the interval

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[35] 42 U.S.C. § 415(a)(1)(B) (pre-retirement), 415(i) (post-retirement).

[36] One might argue that inflation adjustments should be projected at a zero rate to conform to anti-backloading testing methods. *See, e.g.*, Treas. Reg. § 1.411(b)-1(b)(2)(D) (requiring consumer price index to be held constant). Tested under this assumption, previously accrued inflation adjustments would not produce declining rates of benefit accrual. Of course, under this analysis, neither would guaranteed interest credits under a cash balance plan since they would be projected at a zero rate as well.

[37] The use of guaranteed interest credits was first approved in the safe harbor testing method for cash balance plans under the nondiscrimination rules of Code section 401(a)(4). Treas. Reg. § 1.401(a)(4)-8(c)(3)(iv)(A). Treasury and IRS again approved the use of guaranteed interest credits in Notice 96-8, this time for all cash balance plans, not just those relying on the 401(a)(4) safe harbor. IRS Notice 96-8, 1996-1 C.B. 359 (Feb. 5, 1996).

[38] 56 Fed. Reg. 47,528 (Sept. 19, 1991) ("The fact that interest adjustments [*i.e.*, interest credits] through normal retirement age are accrued in the year of the related hypothetical allocation [*i.e.*, pay credit] will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan." (bracketed language added)).

between termination of employment and retirement.[39] None of these reasons for including guaranteed interest credits in a cash balance plan suggests that they are provided on account of an employee's attainment of any age. While Professor Zelinsky dismisses the statement on age discrimination in the 1991 preamble on the ground that a preamble to a regulation cannot override a contrary statute, he overlooks the possibilities that (1) the statute might be read in a way other than the way he reads it, and (2) Treasury and IRS actually were interpreting the statute rather than attempting to override it (strange as that prospect might seem to Professor Zelinsky). Treasury and IRS have the statutory authority to interpret the age discrimination statutes and to coordinate their requirements with the anti-backloading, nondiscrimination, and other requirements applicable to defined benefit plans.[40] Given the inherent problems with Professor Zelinsky's method for determining benefit accrual rates, the role guaranteed interest credits play in helping cash balance plans satisfy the anti-backloading and nondiscrimination rules, and the obvious inflation protection provided by guaranteed interest credits, it is not surprising that Treasury and IRS reached the conclusion they did.

Conclusion. The method for determining rates of benefit accrual proposed by Professor Zelinsky fails to implement the purpose of the age discrimination statutes. On the contrary, his method would undermine those statutes. The method would cause most traditional defined benefit plans to fail the age discrimination rules for accruals after normal retirement age. To avoid this result, his method would need to be limited to accruals before normal retirement age. However, that approach would end up providing greater protection to employees before normal retirement age than after—a result directly contrary to Congressional intent. Even when so limited, Professor Zelinsky's method would cause most contributory defined benefit plans to fail the age discrimination rules for accruals before normal retirement age merely because they included statutory interest credits required by Code section 411(c).

Even if Professor Zelinsky's method were applied to show a declining rate of benefit accrual before normal retirement age in cash balance plans, however, that showing would not demonstrate age discrimination but, at most, a correlation between age and the inflation protection automatically built into cash balance plans in the form of guaranteed interest credits. When tested under Professor Zelinsky's method, most other inflation-protection features in defined benefit plans—including those provided under Social Security—would show similar declining rates of benefit accrual for the simple reason that younger employees face more years of future inflation than older employees do. Nonetheless, there is absolutely no evidence that Congress intended the age discrimination rules to outlaw inflation protections from defined benefit plans. This is not surprising given that inflation protec-

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[39] *See* IRS Notice 96-8, 1996-1 C.B. 359 (Feb. 5, 1996); *see also* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iv)(A) ("The plan benefit formula must provide that the dollar amount of [the pay credit] for each employee for a plan year is automatically adjusted [by interest credits] for the period that begins with a date in the plan year and ends at normal retirement age. This requirement is not satisfied if any portion of the interest adjustments to [a pay credit] are contingent on the employee's satisfaction of any requirement. Thus, for example, the interest adjustments to [a pay credit] must be provided through normal retirement age, even though the employee terminates employment. . . .").

[40] Code § 411(b)(1)(H)(v); ERISA § 204(b)(1)(H)(iv) & (vi); ADEA § 4(i)(5) & (7).

tions, while correlated with age, are not contingent on age. Instead, they reflect an attempt to preserve the value of employees' retirement benefits from the passage of time during which inflation and other factors can be expected to erode the buying power of fixed dollar amounts.

An approach that effectuates Congressional intent without eliminating acceptable and even statutorily required practices in most defined benefit plans would consider merely whether the plan specifies an age at which accruals would be reduced or eliminated. A more quantitative method to accomplish this goal would determine rates of benefit accrual by reference to immediate annuities. Under either or both of these methods, cash balance plans do not violate the age discrimination laws. On the contrary, these approaches show that the guaranteed interest credits provided by cash balance plans are—like inflation protections in other types of defined benefit plans—an important and desirable feature for large numbers of employees.

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November 18, 1999

The Honorable Ida L. Castro
Chairwoman
Equal Employment Opportunity Commission
Room 10006
1801 L Street, NW
Washington, DC 20507

Dear Chairwoman Castro:

Re: **Cash Balance Pension Plan Conversions Do Not Violate the Age Discrimination in Employment Act**

Thank you for inviting the Equal Employment Advisory Council (EEAC) to present comments concerning cash balance pension plan conversions. We are pleased to provide the following analysis concluding that the conversion of a traditional "defined benefit plan" to a cash balance plan does not violate the Age Discrimination in Employment Act of 1967 (ADEA), 29 U.S.C. § 621 *et seq.*

The EEAC is a nationwide association of employers organized in 1976 to promote practical approaches to ending unlawful employment discrimination. Its members include over 315 of the nation's largest private sector companies, collectively providing employment to tens of millions of Americans. EEAC's members are firmly committed to the principles of nondiscrimination and equal employment opportunity. All are employers subject to the ADEA, the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 *et seq.*, the Internal Revenue Code, and other federal laws and regulations affecting employee pension plans. EEAC's member companies fund some of the largest employee pension plans in the United States.

A number of EEAC member companies have converted traditional defined benefit pension plans to cash balance plans and have received favorable determination of qualification letters from the Internal Revenue Service (IRS). In addition, for important reasons discussed in more detail herein, other EEAC member companies are contemplating converting existing defined benefit pension plans to cash balance plans. Consequently, EEAC member companies have a strong interest in the EEOC's interpretation of the ADEA's applicability to cash balance plan conversions.

Features of Cash Balance Plans

Cash balance pension plans are a special type of defined benefit plan. As such, they are eligible to become tax qualified under ERISA. It is important to be aware, however, that cash balance plans themselves come in many different kinds and varieties. Accordingly, while EEAC's comments address features that we believe are typical of the most common types of cash balance plans, we urge the Commission to bear in mind that cash balance plans are not all the same and are not readily amenable to "one-size-fits-all" conclusions.

It also is important to be aware that cash balance plans are not a "new" phenomenon. Indeed, they have been in existence for a number of years and have become an established part of the employee benefits landscape in the U.S. The IRS has issued many determination letters upholding cash balance plans. As importantly, employers and employees have come to rely on the availability of this type of pension plan.

When an employer converts from a traditional defined benefit plan to a cash balance plan, the fundamental elements of the plan remain intact. Therefore, a cash balance conversion is not considered a plan termination under ERISA but rather an amendment to an existing plan. The amendment concerns the benefit accrual formula of the plan. Traditional defined benefit plan accrual formulas have tended to favor older workers, because two chief elements of the most common formulas — years of service and salary — tend to correlate with age. Many defined benefit plans offer a pension benefit that is tied to a percentage of the employee's average salary during the three or five highest consecutive salary years of his or her career. Because most employees receive their highest salary toward the end of their careers, the value of their defined benefits often increases substantially in their last few years of service.

The amended benefit accrual formulas of cash balance plans typically equalize accruals over the course of an employee's entire career. Under a cash balance plan accrual formula, each employee, regardless of age, receives a pension credit based on a percentage of his or her salary, plus interest. The accrual and interest rates usually are the same for all employees — except that some plans use higher accrual rates for older workers (a practice that clearly is permitted by the ADEA). It is very important to stress that no employee loses any accrued pension benefits because of a conversion from a traditional defined benefit plan to a cash balance plan; however, some employees may stand to accrue less benefits following conversion than they would have accrued had the traditional defined benefit plan's original accrual formula remained in effect until their retirement.

In analyzing the effects of a cash balance conversion on employees covered by the plan, it also is important to bear in mind that nothing in ERISA requires an employer to adopt or maintain a defined benefit plan, nor does the law prescribe any specific accrual formula or any

specific level of benefits to be provided. Consequently, although employees have a right to any vested benefits they already have accrued under a defined benefit plan, they have no legal right to expect that the plan will remain in effect in the future or that, if it does, its accrual formula will remain unchanged — any more than an employer has a right to expect that all of its employees will continue working for it until retirement. Thus, an employer's decision to convert a traditional defined benefit pension plan to a cash balance plan may be viewed as an alternative to a lawful termination of the plan.

In weighing a cash balance conversion's effects on employees, therefore, it would be misleading to compare the benefits employees stand to receive following the conversion with the benefits they hypothetically would have received under their old pension plan if it had remained in effect until their retirement. Instead, the focus should be on whether the employees will fare better or worse under the new plan than they would have if their employer had simply terminated their old pension plan. If the law were interpreted in such a way as to prohibit cash balance plan conversions or to make them unduly costly or burdensome for employers, logic argues that many companies would have to seriously consider the alternative of simply terminating their existing defined benefit plans and eliminating this type of pension benefit entirely.

Notwithstanding these practical realities, companies do recognize that some workers approach retirement without anticipating the possibility of changes in their pension plan. Therefore, many companies that have converted to cash balance plans have "grandfathered" certain employees at the time of the conversion, allowing them to remain under the preconversion plan until retirement. Other companies have given employees the choice of which plan they want to pursue. These decisions, however, have not been based on legal requirements but rather on a desire to lessen the effects on employees of a change that they may not have anticipated.

Even after conversion, the steady accrual of benefits under a cash balance plan generally tends to favor older employees over younger ones, for although their credits typically are calculated at the same percentage rates, older employees' salaries tend to be higher and thus yield larger benefits as compared to younger employees. Younger employees, however, generally fare better under the accrual formula of the cash balance plan than they would under a traditional defined benefit plan, because under the cash balance plan their benefits grow more evenly with increasing years of service.

Cash balance plans thus operate in a unique way to the advantage of the overall workforce. They provide flexibility and portability similar to that of defined contribution plans[1], yet retain the stability and security guaranteed by ERISA to defined benefit plans.

There Are Legitimate Business Reasons for Cash Balance Plan Conversions

The primary force driving conversions to cash balance plans has been the evolution of a relatively static labor force into a more dynamic mobile one. During the immediate post-World War II period, many employees worked for a single employer for their entire working career. Today, however, it is more common for workers to change employers (and even careers) several times during a lifetime. Workers today also move in and out of the labor force more frequently, as many take time out to raise families or pursue other interests. Employers competing to attract and retain employees must meet the demands of this evolving mobile workforce, and a cash balance plan conversion is one method that can help to achieve this goal.

Employees who do not expect to remain with their current employer until retirement tend not to favor traditional defined benefit plans that tie their pension benefits to salary averages and, in many cases, do not offer lump sum alternatives. Because most employees' highest salary years come at the end of their careers, traditional defined benefit plans can effectively bind them to a particular employer until they reach retirement age in order to receive the full benefit of the pension plan. Consequently, employers increasingly are providing and employees increasingly have been attracted to the financial flexibility provided by employer-sponsored 401(k), profit sharing, and other defined contribution plans.

Cash Balance Plans Offer Advantages to Employees Over Defined Contribution Plans

The movement away from defined benefit plans and toward defined contribution plans reflects an effort by employers to meet employees' strong desire for flexibility in being able to maintain accrued pension benefits even as they work for more than one employer. Converting a traditional defined benefit plan to a cash balance arrangement, however, has specific advantages for employees over the option of switching to a defined contribution plan.

First, because a cash balance plan is a type of defined benefit plan, the employer continues to bear all investment risk, whereas with a defined contribution plan, the employee makes the investment decisions and bears the risk of investment losses. Second, unlike defined contribution plans, a cash balance plan provides benefits that are guaranteed by the Pension

[1] Under a defined contribution plan, the employer sets up a separate account for each employee with the plan defining the amount the employer will contribute to the account. Thus, the contribution is defined but the benefit is not.

Benefit Guarantee Corporation. Third, cash balance plans are more thoroughly regulated by ERISA and are subject to more stringent notice, funding, and reporting requirements than are defined contribution plans.

Because of the complex regulations ERISA imposes on traditional defined benefit plans and which do not apply to defined contribution plans, traditional defined benefit plans are more costly for employers to implement and maintain. Employers who offer employees traditional defined benefit plans must compete with other companies that may offer their employees benefits that are significantly less expensive to provide. This places traditional defined benefit plan companies in the quandary of wanting to reward employees with the same kind of substantial and stable pension benefits they have provided in the past, yet still compete in today's global marketplace with companies providing less secure benefits at a lower cost. Cash balance plans solve many of these problems by continuing to provide the stability and other advantages of a strictly regulated, defined benefit plan while meeting the demands of the evolving workforce and global competition.

EEAC member companies have conducted extensive economic and labor market studies, as well as legal analyses before converting their traditional defined benefit pension plans to cash balance arrangements. Their legal research has concluded that cash balance conversions do not violate the ADEA, and a careful legal analysis by EEAC staff has reached the same result. The reasons supporting this collective conclusion are summarized below.

The Supreme Court's Decision in *Hazen Paper* Clearly Establishes that Employment Decisions Must Be Based on Age, Not Merely Correlated With Age, To Violate the ADEA

Many aspects of pension benefits are correlated with age. Most significantly, length of service often is used in a traditional defined benefit plan's accrual formula to determine the amount of an employee's benefit. Even in cash balance plans, length of service affects the amount of the benefit an employee ultimately receives, because the longer an employee works under the plan, the more annual credits he or she accrues. As the Supreme Court of the United States recognized in *Hazen Paper Co. v. Biggins*, 507 U.S. 604 (1993), however, length of service is analytically distinct from age. The Court held that, in order to establish a violation of the ADEA, a plaintiff must prove that age "actually motivated" the employer's decisionmaking process," *i.e.*, that it "actually played a role in [the decisionmaking] process and had a determinative influence on the outcome." *Id.* at 610. The Court made clear that an employer's decision is not "necessarily 'age-based'" if based on a factor, such as length of service, that is correlated with but analytically distinct from age. *Id.* at 611.

Cash Balance Plans and Plan Conversions Do Not Involve Disparate Treatment Based on Age

A cash balance plan generally does not make any distinctions among employees based on age. To the contrary, the plan's accrual formula provides each employee with a benefit typically reflecting the same percentage of his or her salary and the same rate of interest as that of every other employee. Any differences in the benefits received by different employees result from differences in their salary levels and the number of years they spend working under the plan — both factors that are analytically distinct from age. Therefore, such plans do not violate the ADEA's general proscription making it unlawful to "discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age." 29 U.S.C. § 623(a)(1).

Nor do cash balance plans violate the provision of the ADEA relating specifically to employee pension benefit plans, which provides that:

> [I]t shall be unlawful for an employer ... to establish or maintain an employee pension benefit plan which requires or permits ... in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age.

29 U.S.C. § 623(i)(1)(A). Nothing in a typical cash balance plan requires or permits the cessation of any employee's benefit accrual or the reduction of a rate of accrual *because of age*. (Emphasis added). On the contrary, such plans typically use standard rates and schedules of accrual that are unrelated to employees' ages.

Furthermore, when converting from traditional defined benefit plans to cash balance plans, companies generally use the same methodology in determining the opening balances in all employees' cash balance accounts, so that all employees are treated in precisely the same fashion regardless of age. Thus, neither a cash balance plan itself, nor an employer's action in converting to such a plan, is the kind of employment action or practice that the Supreme Court intimated in *Hazen Paper* might be actionable under the ADEA because it is based on age or uses an age correlated factor as a proxy for age. See 507 U.S. at 612-13.

To establish a violation of the ADEA under a disparate treatment theory, a plaintiff would have to prove that an employer intentionally converted to a cash balance plan *because of* — not *in spite of* — its allegedly detrimental effect upon older workers. Such unlawful motivation cannot be inferred lightly. As discussed above, cash balance plans offer many practical advantages for employers as well as workers. Because employers have these compelling legitimate reasons to convert to such plans, we believe it will be extremely rare, if

ever, that the Commission will find that an employer's decision to undertake such a conversion was motivated by age-based animus as distinct from legitimate business reasons. See *Goldman v. First Nat. Bank of Boston*, 985 F.2d 1113 (1st Cir. 1993) (no inference of age bias could be drawn from employer's conversion to cash balance pension plan). Accordingly, the disparate treatment theory of discrimination will very seldom, if ever, provide a viable basis for attacking cash balance conversions under the ADEA.

The ADEA Does Not Permit a Cause of Action Based on the Disparate Impact Theory of Discrimination

As a threshold matter, EEAC strongly agrees with the United States Courts of Appeals that have concluded that a valid disparate impact claim cannot be brought under the ADEA. See *Mullin v. Raytheon Co.*, 164 F.3d 696, 702 (1st Cir. 1999), *cert. denied*, 1999 U.S. LEXIS 4840 (U.S. Oct. 4, 1999); *Ellis v. United Airlines, Inc.*, 73 F.3d 999, 1008 & n.14 (10th Cir. 1996); *Lyon v. Ohio Educ. Ass'n, Prof'l Staff Union*, 53 F.3d 135, 138-39 (6th Cir. 1995); *EEOC v. Francis W. Parker Sch.*, 41 F.3d 1073 (7th Cir. 1994). See also *DiBiase v. SmithKline Beecham Corp.*, 48 F.3d 719, 732-34 (3d Cir. 1995), *cert. denied*, 516 U.S. 916 (1995) (expressing court's view that it is "doubtful" that disparate impact theory is viable under ADEA).

The most compelling argument supporting these court decisions is grounded in the text of the ADEA itself. The statute contains an important provision that specifically authorizes employers to differentiate in their treatment of employees "based on reasonable factors other than age." 29 U.S.C. § 623(f)(1). Although the Supreme Court has not decided expressly whether disparate impact claims are actionable under the ADEA, in *County of Washington v. Gunther*, 452 U.S. 161 (1981), the Court interpreted a similar provision of the Equal Pay Act (EPA) — *i.e.*, 29 U.S.C. § 626(d), which permits employers to differentiate in pay rates for men and women based on any "factor other than sex." The Court concluded that this language precludes disparate impact claims under the EPA. *Id.* at 170-71. Inasmuch as the pertinent language of § 623(f)(1) is virtually identical to that of § 626(d), the logic of *Gunther* compels the conclusion that disparate impact claims are not cognizable under the ADEA either. See *Francis W. Parker Sch.*, 41 F.3d at 1077.

Federal courts have found additional support for this conclusion in the ADEA's legislative history and underlying policy — both of which clearly indicate that the ADEA was not meant to include disparate impact-type claims. As Justice O'Connor noted in her opinion for the Court in *Hazen Paper*, the ADEA was passed because of Congress' "concern that older workers were being deprived of employment on the basis of inaccurate and stigmatizing stereotypes" about age. 507 U.S. at 610. After contrasting the disparate treatment and disparate impact theories and reciting the elements of a disparate treatment claim, Justice O'Connor declared that "[d]isparate *treatment*, thus defined, captures the essence of what Congress sought

to prohibit in the ADEA." *Id.* at 610 (emphasis added). Thus, although the Supreme Court did not expressly decide the issue in *Hazen Paper* (because it did not have to), its opinion clearly indicates that disparate *impact* is *not* what Congress had in mind in enacting the ADEA.

Federal appeals courts that have considered the ADEA's statutory purpose have drawn this conclusion expressly. For example, as the First Circuit put it in *Mullin*:

> [t]he imposition of disparate impact liability would not address the evils that Congress was attempting to purge when it enacted the ADEA .... The aging process is inevitable, and Congress was not trying to dissolve those naturally occurring relationships through the medium of the ADEA, but, rather, aimed to protect older workers against the disparate treatment that resulted from stereotyping them as less productive and therefore less valuable members of the work force because of their advancing years.

164 F.3d at 701.

It is important to note, also, that when Congress enacted the Civil Rights Act of 1991, it amended the ADEA in several respects but limited the provision codifying the disparate impact theory of discrimination to Title VII. Thus, 42 U.S.C. § 2000e-2(k) addresses the burden of proof in respect to practices that cause disparate impact on the basis of race, color, religion, sex, or national origin but has no application to claims of disparate impact on the basis of age. This provides additional evidence that Congress never envisioned the ADEA as covering disparate impact claims.

For all of these reasons, EEAC contends that the disparate impact theory is not viable under the ADEA and, therefore, cannot be used as a basis for claiming that cash balance conversions unlawfully discriminate against older workers.

Cash Balance Plan Conversions Do Not Cause Disparate Impact

EEAC recognizes, of course, that three federal circuits have permitted disparate impact claims under the ADEA. See *EEOC v. McDonnell Douglas Corp.*, No. 98-3897, 1999 U.S. App. LEXIS 22024 (8th Cir. Sept. 14, 1999); *District Council 37 v. New York City Dep't of Parks & Recreation*, 113 F.3d 347, 351 (2nd Cir. 1997); *EEOC v. Borden's, Inc.*, 724 F.2d 1390 (9th Cir. 1984). For reasons already stated, we believe the majority view expressed by the other circuits is the correct interpretation of the law. Yet, we would point out that even in the circuits that allow such claims under the ADEA, the disparate impact theory does not provide a viable basis for attacking cash balance plans or plan conversions, because such plans do not cause a disparate impact on older workers because of age.

To make a *prima facie* showing of disparate impact, a plaintiff must identify a particular employment-related practice that, although facially neutral, causes a disparate impact on a protected class of employees because of their protected characteristic. See *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 994 (1988). A *prima facie* disparate impact case, therefore, has three essential elements: a facially neutral policy or practice, disparateness, and a causal connection to the protected characteristic. *Id.* Neither a cash balance plan itself nor an employer's action in converting to such a plan presents all three of these essential elements of disparate impact with respect to age.

Although cash balance plans and plan conversions are facially age neutral, they lack the elements of disparateness and causation. With regard to disparateness, they do not produce dichotomous results as between the protected and unprotected classes under the ADEA. Rather, they produce a myriad of different effects on different members of both groups. In the most recent appellate decision to recognize an age discrimination disparate impact claim, the Eighth Circuit concluded that claims on behalf of subgroups of protected classes are not actionable under the ADEA. *McDonnell Douglas*, 1999 U.S. App. LEXIS at *4-6. As the court observed, unlike race and sex, age is not a dichotomous and immutable characteristic. Instead, each person's age is ever increasing along a continuum which, by definition, has an infinite number of points and can be divided only arbitrarily. Accordingly, not only is there an infinite number of potential age subgroups, but the membership of each subgroup changes from moment to moment as individuals' ages increase.

The continuous spectrum of age — and the infinite number of potential subgroups that results — makes the impact-on-subgroups theory inherently unworkable. Unlike dichotomous characteristics, where there is only one comparator group (*e.g.*, females compared to males), once an age subgroup is chosen for analysis it creates multiple comparator groups, some of which also are within the ADEA-protected class. A cash balance plan or plan conversion will have different effects on employees in different age groupings, both within and outside the overall class of workers aged 40 and over. Moreover, its effects on those in any given age grouping will be changing continuously as the composition of the group changes with time. Consequently, there may be an infinite and varying number of subgroups claiming to be suffering adverse effects in differing degrees, while some members of the statutorily protected group are not adversely affected at all by a cash balance conversion. In such circumstances, the element of disparateness on an overall protected class is impossible to establish.

Nor is it possible to establish a causal connection between any effects a cash balance plan or plan conversion may have on any group or subgroup of workers and the ages of those workers. For again, any such effects of the plan or plan conversion result not from age itself but from other factors which may or may not be correlated with age. These causative factors typically include years of service and salary level — factors which, although correlated with age,

have been specifically recognized by the Supreme Court as being "analytically distinct" from age itself. *Hazen Paper*, 507 U.S. at 611. Thus, a causal connection to years of service or salary level is not a causal connection to age.

As noted above, to establish unlawful disparate impact, plaintiffs must show that they were adversely affected "*because of* their membership in a protected group." *Watson*, 487 U.S. at 994 (emphasis added). Compare 42 U.S.C. § 2000e-2(k)(1)(A)(i) (plaintiff seeking to demonstrate disparate impact under Title VII must show that "a respondent uses a particular employment practice that causes a disparate impact *on the basis of* race, color, religion, sex, or national origin") (emphasis added). *Hazen Paper* makes clear that the existence of a correlation between years of service and age does not mean that "a decision based on years of service is necessarily 'age-based.'" 507 U.S. at 611. In sum, although *Hazen Paper* does not expressly decide the issue of whether disparate impact claims are ever cognizable under the ADEA, the Court's reasoning in that case plainly forecloses any argument that the ADEA prohibits employment practices that have disparate impact because of nonage factors that happen to correlate with age.

The Effects of Interest Compounding Employers' Compliance with IRS Restrictions on "Backloading" and "Wear Away" Do Not Make Cash Balance Plans Violative of the ADEA

Some critics of cash balance plan conversions have argued that a plan's use of the same benefit accrual rate for all employees inherently discriminates against older workers, because an amount of money credited to the pension account of a younger employee will be worth substantially more by the time that employee reaches normal retirement age than the same amount credited to the account of an older employee will be worth when the older employee reaches normal retirement age. If one subscribed to this theory, of course, then 401(k) plans also would have to be considered inherently discriminatory, an obviously absurd conclusion that no one is advocating. The point is that in neither instance is the difference in the ultimate values of the two employees' pension benefits the result of age discrimination. Rather, it is simply a natural consequence of the compounding of interest over differing periods of time. The younger employee, by definition, will have more years of interest compounding than the older employee will have before reaching any normal retirement age specified in the pension plan. The law holds employers responsible for intentional age discrimination, not for the inevitable consequences of aging or of the passage of time.

Nor should employers be held liable under the ADEA for complying with requirements imposed on them by the IRS. The IRS, in enforcing statutory restrictions against "backloading" of defined benefit plans, requires employers that administer cash balance plans to project out the total amount of interest that will accumulate to an employee's pension account on each annual pay credit from the year in which the credit is given until the year the employee reaches the

normal retirement age specified in the plan. The IRS then requires the employer to treat this entire amount of interest, for accounting purposes, as having accrued in the initial year in which the employee received the pay credit. In other words, the IRS requires employers, in effect, to "frontload" cash balance plans, ostensibly to assure that adequate benefits are available for employees who participate in the plans for a relatively short period of time.

As a result of this IRS requirement, when all of the imputed interest is included, the balance of a younger employee's cash balance account may appear to be larger — in some instances substantially larger — than the balance of the account of an older employee with the same annual salary and number of years of service. Again, however, this difference is not the result of age discrimination by the employer. It is solely a consequence of the accounting methodology the IRS has required employers to use in administering cash balance plans. This IRS requirement — like the effects of interest compounding — is a "factor other than age." As such, it cannot be the basis for a finding of unlawful age discrimination under the ADEA.

Finally, there is no merit to arguments that the phenomenon known as "wear away" causes older employees to suffer age discrimination when their employers convert from traditional defined benefit plans to cash balance plans. The term "wear away" relates to situations in which for a period of time following a plan conversion, there is a difference between the hypothetical balance in an employee's cash balance account and the amount of the benefit to which the employee actually is entitled.

This is what happens: At the time of conversion, the employer establishes a cash balance account for each eligible employee and credits that account with an opening balance. This opening balance may be set in a variety of ways and, in some instances, may be less than the amount of the employee's accrued benefit under the prior plan formula. Because of the "anticutback" rule, however, the employee can never receive less than the benefit that he or she already has accrued. Consequently, it may take some period of time before a given employee's hypothetical cash balance grows sufficiently through annual credits and interest compounding to catch up with the amount the employee already is entitled to receive. Often, this occurs in cases of long service employees who already have accrued relatively large vested benefits under a traditional pension plan prior to conversion.

"Wear away" thus is something of a misnomer. No part of any employee's accrued benefit ever is reduced or taken away. Some employees simply may have to wait for a period of time before they become entitled to *more* under the new plan formula than the benefit they already had accrued at the time of conversion. In no respect does this phenomenon involve any action taken by the employer *because of* age, nor does it have disparate impact *because of* age. Rather, any difference in the amount of "wear away" that any two given employees might experience following a plan conversion is strictly a function of *nonage* factors, which may or

may not include differences in salaries, years of service, actuarial assumptions, and interest rates, coupled with the effect of the anticutback rule.

Indeed, it is quite possible that a younger employee who has a substantial number of years of service (and therefore a substantial vested pension benefit) may be subject to so-called "wear away" following a cash balance conversion, while an older employee with only a few years of service (and therefore only a small vested benefit) might not be subject to this phenomenon at all. Again, any such difference occurs because of factors that are *analytically distinct* from age and, therefore, fall outside the purview of the ADEA.

Conclusion

For the foregoing reasons, EEAC respectfully urges the Commission to recognize that cash balance pension plans and plan conversions do not violate the Age Discrimination in Employment Act, and we thank the Commission for the opportunity to submit these comments.

Sincerely,

Jeffrey A. Norris
President

cc: Vice Chair Paul M. Igasaki
Commissioner Reginald E. Jones
Commissioner Paul Steven Miller
General Counsel Gregory Stewart
Legal Counsel Ellen J. Vargyas

June 19, 2000

The Honorable Chuck Grassley
Senate Special Committee on Aging
631 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Grassley:

I would like to add my testimony to your recent Senate Special Committee on Aging hybrid plan hearing held on June 5, 2000. I am an exIBM employee who left IBM last July with 23 years of service. I testified last September at the HELP Committee hearing on cash balance plans; that testimony is attached. At that time, I was still struggling to understand exactly what IBM had done with their pension fund. The most upsetting discovery I've made since then is that IBM initially shifted their employees to a hybrid plan in 1995, not in 1999; the 1999 plan change that received so much press wasn't a typical cash balance conversion at all. Employees were given a choice between two different hybrid plans, both of which are clearly discriminatory to older employees. Much of the pension I was counting on was taken away without my knowledge or consent 6 years ago.

Congress needs to focus just as much attention on why current laws aren't being properly enforced as on writing new ones. Pension promises are made voluntarily, but that shouldn't make them any less binding than any other contractual agreements. IBM employees hired private lawyers and filed a class action suit against IBM last October; I'm not a lawyer and can't review the exact list of laws IBM violated, but I've seen enough of the details to be sure IBM doesn't deserve your applause for being a corporate good citizen. Last May, when IBM announced the cash balance conversion, they listed all of the advantages that were cited by the panelists at your hearing. The remaining paragraphs in this letter contrast each of those claims with what has actually happened at IBM. I've included my recommendation at the bottom.

IBM, like most of the other companies who have converted to cash balance plans, has a vastly overfunded pension plan. In 1999, the surplus in their US fund grew from 6 billion dollars to 11 billion dollars. Because of the overfunding, their annual contribution to the plan (before AND after the conversion) is nothing. Thus when they claimed they did not do the conversion to save costs, they were correct; it is not possible to reduce the price on something that is already free! The June 6, 2000 Wall Street Journal article titled "Companies' Pension Costs Plunge" shows these changes are not about costs at all; they are done to artificially boost the companies' bottom lines, and hence the stock prices.

Like other companies, IBM told us they did the conversion to retain older workers. The cash balance plan actually encourages longer term employees to leave; as their

individual balance grows, they are more and more motivated to leave so they can shift their cash balance to an IRA fund where they have a choice of investment options. (Would you be satisfied if half your lifetime savings were locked into a passbook savings account earning 6% interest?) I beleive demographic figures from IBM for the past year relative to both voluntary and involuntary attrition would show the number and percentage of older workers in the IBM workforce has dropped substantially. Older workers are being actively encouraged to leave; an executive in Rochester recently told a group of employees at an area meeting he was glad to see so many young people in the audience--he congratulated the management team on having replaced so many of the gray hairs. IBM has laid off thousands of workers over the course of the past year; in almost all cases, they have targeted older, long-term workers. For example, in December when they laid off 3.1% of the Rochester, MN site, the average age of the people they laid off was 48.1; the average age of the site was reduced from 40.1 to 39.9.

IBM claimed employees would receive frequent statements listing their earned cash balance; they sent an initial statement before the conversion last June, and haven't sent another since. When employees leave IBM, they are given 30 days to choose between a cash balance and an annuity for their pension fund payout. IBM provides them with estimates to base this life time decision on; IBM agrees to provide final numbers for whichever option is selected up to 1 year later. In my case, I was given a choice between a cash balance number that was 10% lower than I actually earned or an immediate annuity that was almost 50% lower than I actually earned. IBM was clearly encouraging me to choose the cash balance, I assume because that would have limited their obligation.

IBM claimed a cash balance plan is much easier to understand. It may be easier to understand from a context of "how much cash have I earned so far", but it makes planning for retirement much more difficult. As you've said, retirement is a 3-legged stool. Workers can't control how much they will earn from Social Security, but they now receive a statement every several year listing their earnings to date and their estimated social security earnings. Workers have full control over their private savings, and receive monthly, quarterly, or annual statements showing how much they have collected. The problem is their savings are balanced against immediate needs; they only save more if they become convinced they need to. The third leg of the stool, their private pension, is the most mysterious; they need to be able to anticipate, and count on, how much they'll get when they retire, from both their current employer and from any past employers. A pension annuity amount, expressed as a percentage of their final salary, is much easier to plan for than a specific cash balance now.

IBM claimed cash balance plans attract younger workers. The IBM cash balance plan has now been in place for almost a year, but still isn't highlighted on their web-recruiting site. How does it attract new workers if it isn't advertised?

So what should Congress do? The following 5 changes could help substantially:

FASB should be directed to reassess regulation 87, which causes pension fund surpluses to be credited to corporate income statements; if corporations weren't getting artificial boosts from cutting benefits, they would be more inclined to manage these funds for the plan participants.

The EEOC needs to be directed to actively follow-up on the 100s of age discrimination charges that have been filed in the past year; Congress should determine what is needed to help this happen, whether it additional staffing, a readjustment in priorities, or some other problem.

The Department Labor needs to ensure plan administrators are fulfilling all of their fiduciary responsibilities, and not forcing employees to make life time decisions with inadequate information. There should be an employee hot line number, with resources available to research and handle any complaints that are made.

The treasury department should continue the freeze on approving plan amendments for cash balance conversions until the current lawsuits against such conversions are resolved.

Consider legislation requiring annual pension fund statements for all plan participants (even those who left the company and who aren't being paid yet). Everyone is arguing about the expense of calculating a disclosure statement when plans are changed. I don't understand, in this electronic, computerized age, why employee records can't be kept up-to-date and collected together once a year. Banks are not exempted from calculate interest on a $100 savings account, yet IBM doesn't have to correctly calculate a $500,000 pension until up to a year after an employee selected the final payout option. If the third leg of the pension stool is truly so weak that the corporations can't figure out what an employee has earned with intense manual calculations, maybe it is time to redesign the stool...

The retirement security of American workers is seriously in jeopardy. How many of the millions of workers whose pensions have been lost or seriously reduced during the last 15 years are fully aware of what happened? How many have unknowingly entered years of wear away where their pensions are no longer increasing? And how many are saving appropriately to compensate? (Note the compensatory personal savings are needed regardless of whether the reduction was done using a cash balance conversion or some other technique.) You've advocated Congress exercise caution, citing the physician's creed to not harm the patient. Please consider the fact that physicians radically adjust their priorities on the battlefield when patients are bleeding to death; America's pension system is in need of triage, not a simple health checkup. I urge you to take action this year.

Sincerely,

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Statement of Janet Krueger, for inclusion in the record of the United States Committee on Health, Education, Labor and Pensions Hearing on Cash Balance Pension Plans

Ladies and Gentlemen, thank you for inviting me to speak. I am the lead spokesperson for IEBAC, IBM Employee Benefits Action Coalition, a group of IBM employees formed in July of this year. Our group's mission is to convince IBM to restore our pension benefits for 100% of vested employees through any legal means at our disposal, and to ensure laws are in place, and fully enforced, to prevent other corporations from following in IBM's footsteps. Over 50,000 IBM US employees were impacted by IBM's recent conversion to a cash balance plan. About 1,000 of them are now active members of IEBAC. Let me be clear about our goal; we are NOT necessarily against all cash balance plans. There have been some conversions to cash balance plans that seem to be more fair and equitable, plus some companies have offered all their vested employees a choice of plans. But what IBM has done was not fair and equitable; in fact, we believe some of what they've done is not even legal; this continues to be the case, even with the concessions they announced on Friday.

But before I explain what IBM did, let me tell you a little bit about myself. I am a 23-year veteran of IBM. I grew up in an IBM family and lived my whole life in IBM towns. My dad retired from IBM in 1987 after 33 years of IBM service. I went to college on a Watson (IBM) scholarship, then went on to earn an MS degree in Computer Science with a National Science Foundation Fellowship. I have 4 children, ranging from 14 to 21 years old. Two of them are now college students studying computer science. My husband also has a college degree, but has spent the last 21 years as a full time parent.

Over the course of my IBM career, I held a wide variety of jobs in IBM Rochester, and received a number of awards. In my most recent IBM job I worked as a software consultant, teaching

seminars around the world and helping IBM's customers and partners move into the new world of e-business. Over the course of my career, I've received many job offers from other companies. But I was the typical IBM employee, dedicated to advancing our products and supporting our customers; I knew I had a job for life. Several years ago a good friend of mine convinced me to consider joining an independent consultant firm; I actually went out for an interview, but when I balanced the offered 30% raise against my promised IBM pension, and thought about the areas where I still needed to contribute to IBM's success, I decided to stay at IBM.

For decades, IBM has been telling its employees that over 15% of their compensation consisted of contributions to the retirement plan on their behalf. In the 1984 "Planning for your Financial Future" booklet, IBM said "IBM's Retirement plan . . . has long been one of the best in the industry. . . . Your IBM Retirement Plan provides a good, solid foundation income, a secure base for your future retirement."In a 1997 TDSP (401K) newsletter, IBM encouraged employees to take more risk with their 401K money. The newsletter stated " . . . A pension payment is like a fixed income investment. . . A sizable pension payment can make a difference in how you choose to allocate your 401k assets. . . You may be able to take more risk –invest more heavily in equities– in your 401k account."

On July 1 of this year, IBM converted our "good solid foundation income," our "secure base for our future retirement" to a Cash Balance plan. By taking this action, they violated our trust and broke long-standing promises.

When IBM announced the conversion, they said they were helping us out, because the old pension program was "too confusing" and we didn't understand what we were getting. They delivered personalized statements telling us about our new cash balances. Most of us reacted to those statements with complete shock and disbelief. After 23 years of extended overtime and missed vacations, my opening balance was only a little more than 1 year's salary! I spent over a month analyzing both the old plan and the new plan, to try to understand why my new cash balance was so low. I talked to other employees on the internet, in the hope that maybe my figures were in error. But the pattern was clear; every mid-carreer person I talked to had an unbelievably low balance. So we started researching pension laws and trying to understand our rights. Calling IBM HR got us no additional information at all, but in early June someone discovered the magic formula; if you write to a person called the "Plan Administrator",

he is required by law to tell you your vested rights. So lots of us wrote to this plan administrator person. The letter I got back told me that under the old plan, I could collect an immediate annuity equal to almost 9% of my current salary. Which of course generated lots more discussion; what was the relative value of the old immediate annuity to this new cash balance??? How could we compare, and how much had we lost?

This started to remind me of games my older brother and I used to play with my younger brothers; one of the best jokes was that if we offered them a choice between six pennies or a dime, they would always take the pennies to get more coins. And if we offered them a quarter today, or a nickel every day for the next week, they would take the quarter. They clearly didn't understand the value of money; my older and brother and I used to laugh and laugh at their choices. And if mom or dad overheard our trades, and objected to us cheating them out of parts of their allowances, we'd assure them we had full intentions of giving all the money back.

I'm still confused about how to compare the values, and IBM has been unhelpful. Comparing IBM's old pension plan to the new cash balance plan is difficult, because IBM refuses to release any detailed comparison information. My frustrations continue even though I know how to address questions to the "plan administrator." An IBM tool (ESTIMATR) that allowed us to evaluate the previous pension was withdrawn days before the new plan was announced. IBM management assured all of us repeatedly that, when converted to the new plan, "No one loses what they have earned to date." They delivered a new tool called Money@Work. Using that tool I discovered that I could choose between collecting an immediate annuity and a cash balance. It listed a cash balance 3% lower than what listed in my booklet and an immediate annuity 44% lower than what the "plan administrator" said I earned. IBM has said repeatedly that noone lost more than 20% (as if a theft of 20% wouldn't be a theft at all). But my loss sure doesn't look like just 20%.

In every detailed analysis I've looked at the cash balance in the new plan won't be worth as much as the frozen value in the old plan for years. This period of time is called the "wear-away" period. This is confusing so let me convert this to a real example. Let's imagine you deposited $10 in the bank. But when you got your first statement it was only for $5. So you called the bank and complained; the bank manager said he couldn't change the account balances in the computer, but gave you an IOU note for $10, and said whenever you withdrew the money, if it hadn't grown to $10 yet, he would honor the IOU note. Of course, interest is credited on the account balance in the computer, NOT on your IOU note.

IBM said my pension loss would go away, because for the next 7 years, they were going to give me 4 extra transition credits a year, and add 9% of my salary to the cash balance instead of just 5%. Well I'm sorry, but I still don't see how that helps the loss

go away. Remember that bank manager who gave you the $10 IOU, to make up for an account balance of only $5? Would you feel less cheated and exposed if he promised you double interest until your balance matched your IOU???

IBM claims they went far beyond the legal minimum requirements during the conversion by granting those they cut the most some extras. They gave us transition credits (which only are in effect during the wear away period). In reality, all these mid-career employees will accrue no pension benefits at all for years. By the time their generously increasing cash balance catches up to their frozen vested rights from the old plan, IBM reverts to only contributing 5 percent per year for them. By the time they retire, mid-career employees stand to lose hundreds of thousands of dollars under the new plan. In fact, for most of them, their cash balance at age 65 will be worth less than their pension at age 55 would have been under the old plan. Oh, but you might have heard IBM admit that they took away our early retirement benefit. So let's assume I really wanted to work until I was 65; my new cash balance wouldn't have caught up to what the old pension would have been worth at age 65 until I was in my 70s.

IBM also created some things I still don't understand called enhanced annuities. These enhanced annuities are a free will bonus from IBM, so they aren't in the formal plan documentation (which I have been unable to get a copy of, because it doesn't seem to exist yet), so they don't vest. IBM can take them away at any time. Their main purpose, as far as I can tell, is to provide a guarantee that no matter how carefully we analyze the relative values of the old plan and the new plan, IBM will be able to prove our calculations were faulty.

Several IBM executives have stated that they see themselves as much better off with the new Cash Balance pension plan. Of course, that might be due to the fact that at the most recent IBM stockholders meeting a "Supplemental Executive Retirement Plan" was announced, with a projected budget of $157M a year. It is not surprising that someone covered under the new Supplemental Executive Retirement Plan would not be bothered by a reduction in the regular pension plan.

IBM claims they did not give every vested employee a choice of plans because the company could not have saved enough to balance out its benefits package. "It would not have helped our business." Clearly, IBM's savings come from the losses the mid-career employees suffer during the conversion. It should be noted that according to IBM's last annual report, the US pension fund was overfunded by 8 billion dollars. IBM has not contributed anything to the plan since 1995. IEBAC wonders how IBM can be achieving any savings at all; most of us learned in high school that any percentage of zero is still zero.

In our opinion, the excess money in the pension fund should be divided between cost of living increases for current retirees and continued support of the old pension plan for

IBM employees. It should NOT be diverted into other funds, nor should it be used as incentives to attract newer, cheaper employees. Reductions in benefits, such as those IBM achieves by the recent conversion, should not even be under consideration.

Most of the media coverage over the last several months has focused on the pension change at IBM; there was a second, equally damaging change announced at IBM at the same time; the reduction of our retirement medical benefits. Under the new plan, IBMers retiring at age 55 with 30 years of service will be limited to approximately 3 years of medical insurance coverage from IBM. This is another significant reduction in benefits from the old plan that IBM also claims is cost neutral. It can only be cost neutral if IBM expects all their employees to be so stressed out after their years of IBM service that they only live an average of three years!

What is especially hurtful about the IBM conversion is that it is most damaging to the loyal employees who stayed with IBM through tough times and helped them weather the problems of the early '90s. Selfish, mobile people would have left IBM to follow a bigger paycheck. We didn't; we stayed loyal to IBM, sacrificed, and worked hard to rebuild our company. Now that IBM is posting record profits and stock prices, what are our rewards for believing in the old-fashioned ideals of sacrifice, loyalty, hard work, and respect for the individual?

IBM employees have reacted to the IBM's new program in a multitude of ways. Some continue to believe IBM could not have slashed their pensions as badly as we claim; because IBM has disclosed so little information (in fact Money@Work includes a number of false assumptions that cause their future retirement earnings to be vastly overrated such as social security estimates that are over 4 times the numbers provided by the social security administration). Most of these workers won't realize what they lost until they retire and no longer have the ability to make up the difference. Some have decided unions and contracts are the only way to protect future benefits. Many have decided to search for other employment.

Fortunately, I was able to locate a new job in Rochester that lets me continue doing the same kind of job outside of IBM. Since I quit I've become more convinced than ever that IBM is untrustworthy. My separation papers don't include any information about my vested rights. I was given thirty days to choose between the cash balance and the corresponding annuity. IBM says they will refigure my numbers in the second half of the year 2000, using a new calculator that hasn't been written yet, and will adjust my payments if my vested rights are really higher. (Going back to the other analogy, we wonder if the bank manager plans to lose the IOU note that says you really deposited $10.) I have been unable to figure out what formulas they will use for the recalculation even after repeated interrogations of the plan administrators. They're treating me like a guest contestant on "Let's Make a Deal", and letting me choose between door 1 and door 2. But noone has been able to peek behind the doors and give me a clue as to

which one might have the higher relative value. This is NOT the way the company that once had the best HR practices in the world should be treating its employees!!!

While I have a substantial 401K balance set aside that will help lessen the pain for my family, please understand that isn't the case for many IBM employees. IBM employs a wide range of both white and blue collar workers. For example, I know a 39-year old divorced mom who has kids and a mortgage and is making $35,000 per year before taxes; she can't afford to save more for her retirement. Many can't easily find other jobs, especially ones that won't force them to relocate. And they can't count on staying with IBM either. Almost immediately after the conversion, IBM laid off 2000 workers in San Jose. In the last month, they have announced job reductions in Raleigh and Austin. They've also announced that they're selling part of the plants in Rochester and Charlotte. If you survey the IBM work force today and ask them if IBM will keep them employed until they reached age 65, less than 10% would answer yes.

IBM did announce a concession on Friday; they gave to any employees who had served over 10 years and were over 40 as of July 1, 1999 a choice of retaining the old plan. It would be tempting to declare victory and go home. But many of the employees who came with me today still have no choice. Those who now have a choice still don't have adequate tools or information to compare the relative values of the two plans. All of them will still be left providing their own supplements to Medicare insurance if they live too long after they retire. Many would prefer a cash balance kind of plan, but only if IBM would grant them a fair Opening Account Balance (OAB) and some investment alternatives. Employees who left are still being told they won't get actual vested rights amounts from the old plan until the second half of the year 2000. IBM still has work to do. All of our questions about whether the right laws are in place, with the right levels of enforcement, still remain. The disclosure issue, as well as the proper role of "plan administrators" still looms. Current IBM retirees are still left with no COLAs and rapidly increasing co-payments on their health insurance payments. A huge surplus remains in IBM's pension fund; the question about whether IBM has the right to redistribute those funds as incentives for future job performance has not been settled.

These problems are not isolated to IBM. Most companies who haven't yet converted to cash balance plans are actively considering them. This is happening at a time when almost all of America's pension funds are vastly over funded. The billions of dollars in these funds seem to form an irresistible temptation to corporate executives. I know many of you have been struggling with the issue of whether or not to revamp the social security program. Social Security is probably the only pension fund in the United States that doesn't have a huge surplus. If you allow these billions of excess dollars to be diverted from our pension funds, they will be gone, and irretrievable.

The issue needs to be addressed now, this year. STOP the pension theft. Look at the

laws that are already on the books, and make sure the federal agencies and courts are properly enforcing them. Then supplement them in areas where they are inadequate. Senator Harkin's Pension Protection bill provides a good start, but it needs to be passed into law quickly, and more needs to be done. As health care costs escalate and Medicare moves into a state of crisis, please consider protecting retirement health care benefits. Don't let corporate America abdicate from their share of responsibility for America's workers. I'm not a lawyer or an economist; I don't know if there are incentives that would lead them into doing the right things, or if force is required. I do know that this issue is critical, and needs to be addressed during this session.

Thank you for your attention, and for all you've done already. On behalf of the IEBAC organization, I invite you all to visit our http://www.cashpensions.com web site, and reach your own conclusions. There are huge sums of money at stake here, as well as the futures of hundreds of thousands of loyal employees nationwide. As a society we need to do what is fair, what is right, and what is just. THINK about it, and then respond appropriately!

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