The ERISA Industry Committee

Advocating the Employee Benefits Interests of America's Largest Employers

1400 L Street N.W., Suite 350, Washington, D.C. 20005
phone 202-789-1400 / fax 202-789-1120 / e-mail eric@eric.org

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE

SUBMITTED TO
THE COMMITTEE ON EDUCATION AND THE WORKFORCE
OF THE U.S. HOUSE OF REPRESENTATIVES

AT A HEARING
ON
EXAMINING CASH BALANCE PENSION PLANS:
SEPARATING MYTH FROM FACT

July 7, 2004

Introduction

The ERISA Industry Committee ("ERIC") is pleased to submit this statement to the Committee on Education and the Workforce for the Committee's consideration in connection with its hearing on cash balance pension plans.

ERIC commends Chairman Boehner, Ranking Minority Member Miller, and all the members of the Committee for holding this hearing. This hearing is a welcome step toward developing an informed understanding of what cash balance and pension equity plans ("hybrid plans") are, the benefits they provide, and the people who benefit from them. We strongly support the Committee's effort to get at the facts and to distinguish myth from reality.

The issues are vital. The future of the private defined benefit plan system is at stake.

The defined benefit plan system is already in decline. Employers that have converted traditional defined benefit plans to hybrid plans have determined that a traditional defined benefit formula does not work for them or their employees. These employers are not likely to return to a traditional pension formula. If Congress errs in its treatment of hybrid plans, employers will have additional incentives to abandon defined benefit plans in greater numbers and at an accelerated rate, disrupting the lives and financial security of the millions of working Americans and their families who now rely on these plans and placing even greater strains on Social Security and other public programs. The consequences will be tragic and unnecessary -- not only for the participants and beneficiaries involved but for the Nation as a whole.

Only by carefully studying the issues can Congress avoid potentially irrevocable and calamitous results. We look forward to working with the Committee and its staff as they study these critical issues

Executive Summary

- When Congress considers legislation regarding hybrid plans, it has a responsibility to understand fully how the legislation will affect employers' willingness and ability to sponsor these plans and the benefits that employees will receive from them. We look forward to working with the Committee to expand the knowledge base regarding hybrid plans.

- Voluntary defined benefit retirement plans meet critical retirement security and economic needs.

- In recent years, federal law has not fostered the formation, continuation, and expansion of voluntary defined benefit retirement plans. Future legislation should insure that the formation, continuation, and expansion of voluntary defined benefit plans are viable options for employers.

- It is imperative that an employer's ability to make prospective changes in benefit plan design be preserved if defined benefit plans are to flourish in the future. If employers lose the ability to change their benefit plans in order to respond to changing business circumstances, they will have an even greater incentive to abandon their benefit plans.

- Hybrid plans respond to the needs of a changing economy. They work well for many employers, employees, and the entire Nation.

- Hybrid plans do not invariably reduce benefits.

- Hybrid plans are not age discriminatory.

- Treasury Department guidance has confirmed the lawfulness of hybrid plans.

- ERIC looks forward to working with the Committee on proposals to ensure that defined benefit plans, including hybrid plans, remain a viable retirement security option for employees and retirees in the future.

ERIC

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, welfare benefit, and incentive plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. 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 has played a leadership role in advocating responsible solutions to the critical retirement and health care coverage issues that face our Nation. ERIC has published policy papers and studies that have received wide acclaim and have been instrumental in the formulation of legislative and regulatory policy. These include, among others–

– *The Vital Connection: An Analysis of the Impact of Social Security Reform on Employer-Sponsored Retirement Plans,*

– *Getting the Job Done: A White Paper on Emerging Pension Issues,* and

– *Policy Statement on Health Care Quality and Consumer Protection.*

ERIC and its members have worked for approximately 30 years to resolve important policy questions and to devise practical solutions to the often vexing problems facing the Committee and the country.

Voluntary Defined Benefit Retirement Plans
Meet Critical Retirement Security And Economic Needs.

Before we address the specific subject of this hearing – cash balance and plans and pension equity plans – it is important to emphasize the important role of voluntary defined benefit retirement plans in our Nation's economy.

It is also important to emphasize that the strength of the employer-sponsored benefit plan system depends on the system remaining *voluntary*. Employers are not required to provide retirement plans for their employees. Employers provide retirement plans voluntarily because it is in both their employees' interest and their own interest to do so.

Defined benefit retirement plans have played a critical role in helping to meet many employees' retirement security needs, a role that differentiates defined benefit plans from defined contribution plans:

- They provide a reliable source of retirement income to plan participants and their beneficiaries.

- They act as a form of automatic savings: benefits accrue automatically under most defined benefit plans.

- Employees are sheltered from investment and other risks that can reduce individual retirement savings.

- Once vested, the employee is virtually guaranteed whatever benefit he or she has earned under the plan.

- The employer is responsible for funding the plan. If the employer becomes bankrupt, the Pension Benefit Guaranty Corporation ("PBGC") guarantees payment of most benefits.

- Defined benefit plans make benefits available as an annuity. If a retiree takes an annuity, the plan, not the retiree, bears the risk that the retiree will outlive his or her life expectancy.

Defined benefit plans also help many employers to attract, retain, and motivate employees. In addition, defined benefit plans are major investors in the economy and make major contributions to national savings, investment, and economic growth.[1]

The Decline in Defined Benefit Plan Coverage.

Although defined benefit plans provide valuable retirement security benefits to the millions of employees who participate in them, the coverage of these plans is declining:

- Between 1979 and 1998, the number of defined benefit plan participants fell by over 22%, from 29.4 million to 22.9 million.[2]

- Between 1985 and 2000, the number of active participants in PBGC-insured defined benefit plans fell by about 15%, from almost 27 million to less than 23 million -- notwithstanding the expansion of the total workforce during this period.[3]

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[1] As of December 31, 2001, private-sector defined benefit plans held assets valued at $1.81 trillion. Staff, Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Benefit Plans,* at 33-34 (JCX-71-02) (June 18, 2002).

[2] U.S. Dep't of Labor, Pension & Welfare Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports* No. 11, at Table E8 (Winter 2001 - 2002).

[3] Pension Benefit Guaranty Corporation, *2002 Annual Report*, at 14 ("The number of active workers PBGC insures actually fell from almost 27 million in 1985 to less than 23 million in 2000. Meanwhile, the labor force has grown. Now only about 20 percent of private-sector wage and salaried workers are covered by PBGC-insured defined benefit pension plans, down from 30 percent in 1985. If the trend continues, active participants will constitute less than half of PBGC-insured participants in 2003.").

Why has this happened? From the early 1980s until 1994, Congress piled law on top of law in an effort to meet Congressional budgetary targets by squeezing as much "tax revenue" out of defined benefit plans as it could. Through these laws, Congress created a regulatory climate that not only micro-managed these plans, but also strangled employers' ability to fund these plans for the future. The result was to subject defined benefit plans to a bewildering array of complex, rigid, and inconsistent legal requirements.

The resulting legal regime has been excessive, oppressive, and convoluted. Its primary effect has been a *decline* in retirement security, as employees have found the rules to be bewildering and as employers have found sponsoring a plan to be increasingly burdensome and unwieldy. It has discouraged employers from adopting new plans and encouraged many to terminate their existing plans. For example:

- Restrictive, complex, and frequently amended legal requirements, including compensation and benefit limits and distribution rules have required plans to invest a substantial portion of their resources in legal compliance and plan administration, rather than in providing benefits to participants and beneficiaries.

- New short-sighted funding rules have subjected employers to unrealistic funding assumptions, ignored the long-term nature of pension obligations, and limited employers' ability to fund their defined benefit plans until late in their employees' careers.

- Rigid restrictions on the use of pension assets have converted a defined benefit plan into a "black hole" from which contributions cannot emerge -- even if the plan's assets vastly exceed the amount required to fund the plan's benefits.

This regime has weakened retirement security by restricting funding opportunities when employers are most able to fund, by increasing funding requirements when employers are least able to fund, by subjecting employers to highly volatile funding requirements that are difficult, if not impossible, for employers to predict, by subjecting plans to excessive administrative costs, by confusing employees, and, in the aggregate, by making it less attractive for employers to maintain and contribute to defined benefit plans. It is difficult to imagine a regime less likely to encourage the establishment and continuation of defined benefit plans.

The decline in defined benefit plan coverage has substantially weakened the retirement security of our Nation's workforce.

Federal Law Should Ensure That The Formation, Continuation, And Expansion Of Voluntary Defined Benefit Retirement Plans Are Viable Options For Employers.

Federal law must create an environment that is conducive to plan formation, continuation, and expansion. If federal law makes it too costly or impractical to maintain a plan, or subjects plans to irrational or counterproductive rules, employers will refrain from creating new plans and will be encouraged to terminate or curtail the growth of existing plans. If federal law makes it difficult or impossible for an employer to modify an existing plan – if adopting a voluntary plan locks an employer into a permanent commitment to maintain the plan without change – employers will be loathe to adopt these plans. If an employee benefit plan becomes a straight jacket from which there is no escape, employers will respond by not adopting plans. The drafters of ERISA understood this well. As the late Senator Jacob Javits (R-N.Y.) observed:

> "The problem, as perceived by those who were with me on this issue in the Congress, was how to maintain the voluntary growth of private plans while at the same time making needed structural reforms in such areas as vesting, funding, termination, etc., so as to safeguard workers . . . [T]he new law represents an overall effort to strike a balance between the clearly-demonstrated needs of workers for greater protection and the desirability of avoiding the homogenization of pension plans into a federally-dictated structure that would discourage voluntary initiatives for further expansion and improvement."[4]

The Employer's Ability To Change The Design Of Its Retirement Plan Must Be Preserved.

One of the great strengths of our Nation's retirement security system is the flexibility it currently provides to an employer to design and adjust its plans to respond to changing business circumstances and to the changing needs of the employer and its employees.

The rapid emergence of new technologies and the obsolescence of old products and services are reshaping many industries, forcing companies in those industries to adapt quickly or -- like buggy whip manufacturers in the age of internal combustion engines -- die. Businesses change their ways of doing business, move into new businesses, merge, form joint ventures, acquire other companies or are themselves acquired, and divest old lines of business or are themselves divested as they adjust to challenges and opportunities in today's highly competitive international marketplace. New global competition and competition from emerging companies have made it essential for employers to change their employee rewards programs.

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[4] Address by Senator Jacob K. Javits, *Briefing Conference on Pension and Employee Benefits*, New York State School of Industrial and Labor Relations, Cornell University and Federal Bar Association, Washington, D.C. (Sept. 19, 1974).

If employers lose the right to change their retirement plans to respond to changing business conditions, the consequences will be disastrous for employers, employees, and the U.S. economy.

Employees And The Economy As A Whole Will Be Harmed If Employers Are Prevented From Changing Their Plans To Respond To Changing Business Circumstances.

Under current law, employers may not amend their plans to reduce benefits that have already accrued. But employers have always had the right to change their plans *prospectively* – to change the terms governing benefits that have not yet been earned.

The employer's right to make *prospective* changes in benefits is essential to the vitality of the U.S. economy and to new and expanded employment opportunities. It is also essential to our voluntary benefit system. As we have explained, elimination of the right to make prospective benefit changes will deter employers from adopting benefit plans. If the right to make prospective changes is eliminated, the principal victims will be *employees and their families* – who will no longer receive the critical benefits that these plans provide. The harmful consequences are predictable: less retirement savings, less retirement security, greater poverty among the elderly, greater pressure on older employees to continue working, increased financial catastrophes for workers of all ages, greater demands on public assistance programs, greater demands on Social Security, and less investment capital for the economy.

Moreover, if employers lose the right to change the terms on which benefits will be earned in the future, employers that have benefit plans will have their options severely limited. When subject to financial pressures, employers will not be able to reduce costs by reducing future benefit levels and will be forced to adopt alternative measures such as reductions in pay levels, cutbacks in health benefits, layoffs, and outsourcing. Under these conditions, employers with retirement plans will be at a severe competitive disadvantage *vis a vis* employers that do not have them. The impact on these employers, their employees and retirees, and the economy as a whole will be devastating. Many employers will decide to terminate their plans rather than allow themselves to be in this position.

Most Traditional Defined Benefit Plans Focus Most Of Their Benefits On A Small Group Of Employees.

Under most traditional defined benefit plans, employees earn most of their benefits only after completing 20 to 30 years of service with the same employer. The value of their benefits spikes after they qualify for subsidized early retirement benefits, typically in their mid-50's or later, but then declines if they choose not to retire and keep working. Although the dollar amount of the plan's monthly retirement benefit typically does not decline, the *economic value* of the retirement benefit does decline if the employee delays retirement; this is because the value of the plan's early retirement subsidy declines as the employee approaches the plan's normal retirement age.

As a result, traditional defined benefit plans are most advantageous to the relatively small group of employees who work for the same employer for 20 to 30 years and retire at the plan's early retirement age. They are far less beneficial for others -- for employees who change jobs or interrupt their careers and for older employees who continue to work after early or normal retirement age.[5] Indeed, this has been a major criticism of defined benefit plans for many years.

Although traditional defined benefit plans are appropriate for some employers and some work forces, they do not meet the needs of many employers and employees.

Hybrid Plans Respond To A Changing Economy.

Many workers in changing industries no longer look forward to a lifetime career with one employer. They expect to change employers more frequently than their parents and grandparents did. A retirement plan that requires workers to stay with the same company and wait for a big bump-up in the value of their pension benefits in the last few years of employment penalizes workers who, for one reason or another, leave an employer early or in mid-career and offers little incentive to join an employer recruiting for top talent.

Recently, new hybrid plan designs, such as cash balance defined benefit plans and pension equity plans, have been embraced by employers and employees alike who need benefit plans that match the new environment in which they work. In contrast to traditional

[5] "Overall, defined benefit pension wealth -- the present value of the expected future stream of [traditional] pension benefits -- grows slowly early on in an individual's career, increases rapidly near the end, and then declines at older ages." Johnson & Uccello, Urban Institute, C*an Cash Balance Plans Improve Retirement Security for Today's Workers?*, at 2 (2002). "[T]raditional DB pensions have imposed large benefit cuts on employees who left the firm prior to retirement age. This is because most traditional DB formulas usually link retirement payments to final pay at the company . . . ." Mitchell & Mulvey, Pension Research Council, Wharton School, University of Pennsylvania, *Possible Implications of Mandating Choice in Corporate Defined Benefit Plans*, at 3 (2003). "[P]ension accruals in traditional DB plans are minimal at younger ages, grow rapidly in the later 40s and 50s as workers approach retirement age, and then become negative as workers lose pension wealth when they remain at work past the plan's retirement age. For workers in their early 60s who have participated in the DB plan since age 25, for example, pension wealth declines on average by about 14 percent of annual salary each year." Johnson & Steurle, Pension Research Council, Wharton School, University of Pennsylvania, *Promoting Work at Older Ages: The Role of Hybrid Pension Plans in an Aging Population*, at 21 & Fig. 12 (2003).

defined benefit plans, hybrid plan designs have stimulated great interest in retaining and expanding defined benefit plans.[6]

The growth and popularity of these new defined benefit arrangements is supported by the findings of numerous independent analysts, as illustrated by the following conclusions:

> "[G]iven the emergence of vehicles such as 401(k) plans and hybrid plans, retirement plans today match the reality of the work experience for most Americans better than at any time in the past."[7]

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> "[W]orkers employed by more than one employer during their career can receive more retirement income under multiple cash balance plans than under multiple traditional defined benefit plans. . . . [In one example, the] benefit earned by the worker who changed employment under multiple cash balance plans will accrue a retirement benefit that is almost 22 percent larger than the benefit received by the workers under multiple [final average pay] plans."[8]

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> "Median lifetime pension wealth would increase under cash balance plans because these new plans distribute pension wealth more equally across the covered population."[9]

See also Appendix.

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[6] "During the middle and late 1990s, hybrid plans, primarily cash balance plans, became a growing percentage of the plans PBGC insures. . . . In 2000, hybrid plans contained an estimated 20 percent of all PBGC-insured single-employer plan participants." Pension Benefit Guaranty Corporation, *2002 Annual Report*, at 14.

[7] Yakoboski, Employee Benefits Research Institute, *Debunking the Retirement Policy Myth: Lifetime Jobs Never Existed for Most Workers*, at 1 (1998).

[8] General Accounting Office, *Cash Balance Plans: Implications for Retirement Income*, at 26-27 (2000).

[9] Johnson & Uccello, Urban Institute, *Can Cash Balance Pension Plans Improve Retirement Security for Today's Workers?*, at 3 (2002).

Hybrid Plans Meet Employee Needs.

Benefits Are Understandable: Unlike traditional defined benefit plans, cash balance plans provide an easily understood account balance for each participant. Employees – who are accustomed to dealing with bank account balances, § 401(k) account balances, and IRA balances – are comfortable with a retirement plan that provides a benefit in the form of an account balance.

Savings Accrue Automatically: Unlike § 401(k) plans, amounts are added automatically to the accounts of *all* employees eligible to participate in a hybrid plan. The employee does not have to make an affirmative choice to participate or make often difficult decisions about how much of his or her current income to defer.

The Employer Bears The Risk: Like traditional defined benefit plans, but unlike defined contribution plans (*e.g.*, § 401(k), money purchase plans, or profit sharing plans), investment risks are borne by the employer. Sudden or even prolonged downturns in the equity or bond markets do not affect the defined benefit promised to the participant.

Benefits Are Guaranteed: Like traditional defined benefit plans, but unlike defined contribution plans, benefits are insured by the PBGC, a government agency.

Greater Benefits For Short-Service Employees: An employee typically earns most of his or her benefit under a traditional defined benefit plan in the last few years before retirement. By contrast, a hybrid plan delivers benefits more evenly over the employee's career, and an employee who leaves before retirement can roll over his or her benefit, on a tax-deferred basis, to an IRA or a new employer's plan. Thus, hybrid plans are especially attractive in new industries that tend to attract highly talented, mobile workers as well as in industries that are undergoing significant changes.

Women Benefit: Hybrid plan designs offer significant advantages to women (who are most threatened by impoverishment in old age) and others who tend to move in and out of the workforce. *In fact, all mobile workers -- not just women -- are more likely to accrue a significant and secure retirement benefit under cash balance plans than under many other plan designs.*[10]

[10] "Compared with traditional pensions, cash balance plans generate retirement wealth more evenly over time for a couple of reasons: Contributions made early on earn interest for many years, and lifetime earnings rather than final earnings determine benefits. Consequently, a worker changing jobs incurs only a small penalty. For women, who tend to have higher turnover rates than men, the ability to change jobs without jeopardizing pension wealth may be particularly important." Johnson & Uccello, Urban Institute, *Can Cash Balance Pension Plans Improve Retirement Security for Today's Workers?*, at 2 (2002).

Older Workers Benefit: The advantages of a hybrid balance plan design are not limited to mobile workers, however. For example, the value of the benefit for an older worker participating in a hybrid plan increases at the same rate both before and after normal retirement age (and , in some plans, increases at a higher rate as the employee accrues additional years of age or service). By contrast, under a traditional defined benefit plan, particularly those that offer subsidized early retirement benefits, the economic value of an employee's benefit actually declines when an employee works past the plan's early or normal retirement age.[11]

Portability: Hybrid plans provide portable benefits that can be rolled over to another employer's plan or an IRA, on a tax-deferred basis, for continued retirement savings. In addition, when companies are merged, acquired, or form joint ventures, the benefits are easily transferred to a new plan, making continuity more attractive to the new employer and making it more likely that affected employees will achieve retirement security.

Employee Control: Since the amounts payable under hybrid plan benefits are more easily understood by employees than are the benefits under many traditional defined benefit plans, employees are more likely to take responsibility for their retirement and their future, resulting in greater personal and national savings.

No Penalties: Unlike many traditional defined benefit plans, hybrid plans do not penalize employees who wish to move on to other jobs before reaching retirement eligibility:

> "Traditional DB plans generally encourage early retirement, by offering early retirement subsidies and delayed retirement penalties. As a result, DB plan sponsors seeking to keep their older workers on the job found that their traditional plans did not serve business

[11] "[P]ension accruals in traditional DB plans are minimal at young ages, grow rapidly in the late 40s and 50s as workers approach retirement age, and then become negative as workers lose pension wealth when they remain at work past the plan's retirement age. For workers in their early 60s who have participated in the DB plan since age 25, for example, pension wealth declines on average about 14 percent of annual salary each year. . . . In effect, DB plans favor a select group of longer-term employees, often in late middle-age, but disfavor both younger and older workers. Unlike traditional DB plans, hybrid pension plans, such as cash balance plans and pension equity plans, often reward work at older ages at least as much as work at younger ages, because workers in hybrid plans do not forgo a year of benefits for every year they remain on the job past the retirement age." Johnson & Steurle, Pension Research Council, Wharton School, University of Pennsylvania, *Promoting Work at Older Ages: The Role of Hybrid Pension Plans in an Aging Population*, at 21, 24 & Fig. 12 (2003).

> objectives. By contrast, hybrid plans eliminate early retirement incentives and do not have a 'spike' in accrual rates shortly before normal retirement age. Thus workers who leave early are not penalized as was the case of most DB plans, which provided larger accruals for longer tenured employees close to retirement."[12]

Annuities Are Available: Since annuities must be offered by a hybrid pension plan, participants who want to receive their retirement benefit as a stream of income avoid the increased cost and difficulty of purchasing annuities in the individual market. By contrast, if an employee who participates in a defined contribution plan wishes to receive the balance in his or her defined contribution account as an annuity, the employee must approach one or more insurance companies and purchase an annuity on whatever terms are then available to an individual purchaser in the annuity market.

Hybrid Plans Meet Employer Needs.

Appropriate Employment And Retirement Incentives: Because hybrid plans deliver benefits evenly throughout an employee's career, they do not provide undue incentives for employees to keep working for the same employer until reaching retirement age or to retire immediately when they do qualify for retirement.

Improved Employee Communication: Because benefits in hybrid designs are more understandable, retirement benefits and the need to save are more easily and effectively communicated to all employees, including those who ordinarily do not pay much attention to retirement issues.

Improved Employee Recruitment and Retention: Hybrid plans are an effective tool for attracting new employees and retaining and rewarding current employees.

Enhanced Benefit Coordination: Hybrid plans are easily coordinated with the employer's savings or profit-sharing plan.

Neutral Impact On Enterprise Decisions: Because cash balance and hybrid plan designs of different companies can be coordinated relatively easily, they offer a stable "platform" to retain employees for companies engaged in mergers and acquisitions.

[12] Mitchell & Mulvey, Pension Research Council, Wharton School, University of Pennsylvania, *Possible Implications of Mandating Choice in Corporate Defined Benefit Pension Plans*, at 4 (2003) (citation omitted).

Hybrid Plans Benefit The Nation.

Capital Accumulation: Defined benefit plans -- which include hybrid designs -- have for decades been an engine of capital accumulation, making available secure sources of capital for business start-ups and economic expansion that have been responsible for the outstanding success of the American economy.

More Efficient Retirement Savings: Because of the longer investment horizon available under a defined benefit plan, a hybrid plan can invest its assets more aggressively and can better withstand market downturns while still providing a full benefit than can an individual participating in a defined contribution plan, who must bear all of the investment risk under the plan.

Increased Retirement Savings: Under hybrid plans, more workers build larger savings earlier in their careers, increasing their opportunity to accumulate significant retirement savings and reducing the pressure on government programs in their retirement years.

Increased Pension Participation: All eligible employees automatically accrue benefits under hybrid defined benefit plans. Because benefit accrual does not depend on an employee's election to participate, more employees whose employers provide a defined benefit pension plan will actually benefit from the plan.

More Compatible Workplace For Women: The design of a hybrid plan can enable an employer to offer a total compensation package that allocates value more equitably between long-service employees and women and others who tend to move in and out of the workforce. Hybrid plans will help to address the phenomena of the considerable number of elderly poor women with insufficient pension resources and the resulting pressure to increase targeted entitlements.

Less Pressure On Government Programs: By providing a reliable source of retirement income, defined benefit plans, including hybrid plans, reduce pressure on government entitlement programs for the elderly.

Employers Have Always Reserved The Right To Revise Their Benefit Plans.

Employers have always had the right to change the retirement plans they provide to their employees. It is a fundamental principle of ERISA. Although current law protects an employee's accrued benefit (including early retirement rights related to the employee's accrued benefit), the law has always allowed an employer to change the terms on which retirement benefits will be earned in the future. As we have explained, if an employer did not have the right to make such changes, employers would be deterred from voluntarily adopting retirement plans in the first place.

Employers frequently make changes in their retirement plans – both major and minor – to accommodate changing employee preferences, to respond to changing competitive, financial, and other conditions, and to achieve specific business objectives. Employees are well aware of the employer's right to change the plan, and have frequently benefited from those changes.

Employees are adequately protected by current law. The law not only prohibits an employer from amending a plan to reduce the pension benefits that employees have already earned, but also requires the plan, after it has been amended, to continue to give employees credit for their service for purposes of qualifying for any early retirement subsidy that applies to the pension benefits that the employees had earned at the time of the plan amendment. For example, if an employer amends a pension plan to provide that pension benefits earned in the future will not include an early retirement subsidy, employees are still entitled, after the amendment, to continue to earn service credit for purposes of qualifying for any early retirement subsidy that applies to the pension benefits they have already earned.

Hybrid Plans Do Not Inherently Reduce Benefits.

Some critics of hybrid plans have claimed that employees will earn retirement benefits under these plans that are less than the benefits that those employees would have earned if the prior plan formula had remained in effect without change. However, independent studies debunk this claim:

> ". . . [I]t does not appear that most firms are seeking to reduce benefit generosity. . . . Cash balance conversions appear to be largely driven by labor market conditions. . . . [T]he move toward DC-like pensions is likely the result of increased worker mobility."[13]

Ultimately, any comparison between the benefits provided by a hybrid plan and the benefits provided by a traditional defined benefit plan depends on the terms of the plans. Hybrid plans do not inherently provide benefits that are greater or less than the benefits provided by traditional plans. Also, as explained earlier, current law prevents a plan amendment from causing an employee to lose any part of the accrued benefit that he or she has already earned.

In addition, hybrid plans tend to distribute the benefits accrued by plan participants more evenly among employees than do traditional defined benefit retirement plans:

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[13] Coronado & Copeland, Pension Research Council, Wharton School, The University of Pennsylvania, *Cash Balance Pension Plan Conversions and the New Economy*, at 23 (2003).

> "By distributing pension wealth more equally across the population than [traditional defined benefit] plans, cash balance plans would increase median lifetime pension wealth in the total covered population and more people would gain pension wealth than lose."[14]

Hybrid Plans Are Not Age Discriminatory.

Claims have been made that hybrid plans invariably violate the Age Discrimination in Employment Act ("ADEA"). These claims lack merit.

Of the four federal district courts that have considered the issue, three have rejected the claim that hybrid plans are age discriminatory. Although one court reached a contrary conclusion, that court's conclusion was subsequently rejected by another federal district court last month.[15]

On its face, a cash balance plan is not age-discriminatory. Each participant, regardless of age, receives the same percentage-of-compensation pay credit -- except for the many plans that provide *higher* pay credits to older workers. The rate at which interest credits are calculated on the participant's cash balance account is age-neutral.[16] Under a pension equity plan, an employee's rate of benefit accrual commonly increases with additional years of age or service.

Claims that hybrid plans are age-discriminatory are based on the theory that because a younger employee will benefit, when the employee reaches retirement age, from a longer period of interest-compounding on his or her account balance than will an older employee, the plan discriminates in favor of the younger employee. What these claims gloss

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[14] Johnson & Uccello, Urban Institute, *The Potential Effects of Cash Balance Plans on the Distribution of Pension Wealth at Midlife*, at 29 (2001).

[15] Compare *Tootle v. ARINC, INC.*, Civ. Act. No. CCB-03-1086 (D.Md. June 10, 2004) (rejecting age discrimination claim), *Engers v. AT&T*, Civ. Act. No. 98-CV-3660 (NHP) (D.N.J. June 6, 2001) (same), and *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000) (same), with *Cooper v. IBM,* 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (accepting age discrimination claim). *See also Campbell v. BankBoston, N.A.*, 327 F.3d 1, 10 (1st Cir. 2003) (recognizing problems with age discrimination theory) (dictum).

[16] "By contrast, many employers today prefer hybrid plans because they smooth compensation differentials by age and soften the incentives for early retirement. As a consequence of the new plan elements, hybrid plans are in fact *less* age discriminatory than many traditional DB plans." Mitchell & Mulvey, Pension Research Council, Wharton School, University of Pennsylvania, *Possible Implications of Mandating Choice in Corporate Defined Benefit Plans*, at 18 (2003) (emphasis original).

over is that the younger employee must wait longer in order to receive the benefit of the longer period of interest-compounding. The accumulation of interest credits for a longer period of time merely compensates the employee for having to wait longer to collect a benefit from the plan at retirement age.

Cash balance plans are not age-discriminatory for the same reason that Social Security is not age-discriminatory. Both plans index employees' pension benefits prior to retirement: cash balance plan benefits are indexed with interest, while Social Security benefits are indexed for increases in average national wages and the cost of living. These pre-retirement indexing features protect employees against inflation; they are not age-discriminatory.

Some have claimed that when a traditional defined benefit retirement plan is converted to a hybrid plan design, the "wear-away" feature used to transition from the old formula to the hybrid plan formula discriminates against older workers. Where wear-away occurs, an employee who participates in the plan at the time of conversion typically receives the greater of two benefits: (1) the employee's accrued benefit under the old formula at the time of conversion *or* (2) a benefit based solely on the plan's new hybrid plan formula plus interest.

Depending on the details of the two formulas, an employee with a very substantial accrued benefit under the plan's old formula might find that he or she has no increase in benefits, especially early retirement benefits, for some period of time, while a more recently-hired employee might begin to accrue additional benefits immediately. However, this is not the result of age discrimination. If neither the plan's old formula nor the plan's new formula is age-discriminatory, there is no basis for claiming that a plan that provides an employee with *the greater of* the benefits provided by the two formulas is age-discriminatory. Indeed, in the past, Congress and the Treasury Department have both required and permitted plans to provide participants with the greater of their previously accrued benefits under the old plan formula or the benefits they accrued under a new plan formula.[17]

[17] *See, e.g.,* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1106(i)(3), 100 Stat. 2085, 2425-26 (1986); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 235(g)(4), 96 Stat. 324, 508-09 (1982); ERISA, Pub. L. No. 93-406, § 2004(d)(2), 88 Stat. 829, 987 (1974); S. Rep. No. 575, 98th Cong., 2d Sess. 29 (1984) (a participant who meets the criteria for an early retirement subsidy that was previously eliminated by a plan amendment is entitled to the greater of the portion of the subsidy attributable to service before the plan amendment or the retirement benefit provided under the plan as amended); Treas. Reg. §§ 1.401(a)(4)-13(c)(4) (listing permissible "fresh-start" formulas), 1.401(a)(17)-1(e) (applying "fresh-start" formulas where Code § 401(a)(17) limits were reduced); Notice 88-131, 1988-2 C.B. 546 (Alternative IID) (providing that certain participants may be entitled to the greater of the benefit accrued under pre-existing plan

(Footnote continued)

**Treasury Department Guidance Has Confirmed
The Lawfulness of Cash Balance Plans.**

Hybrid plans have been on the scene for nearly 20 years, and the Government has indicated on numerous occasions that hybrid plans are lawful. Employers have reasonably relied on Government guidance in adopting hybrid plans:

Preamble to the Final § 401(a)(4) Regulations: In the preamble to the final regulations creating a safe harbor for cash balance plans from the restrictions on discrimination in favor of highly compensated employees, the Internal Revenue Service stated unequivocally that cash balance plans were *not* age-discriminatory:

> "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."[18]

Regulatory Safe Harbor for Cash Balance Plans: The IRS safe harbor for cash balance plans strongly implied that such plans were lawful. Surely, the IRS would not have created a safe harbor for cash balance plans unless it believed that these plans were lawful.[19] In fact, as the preamble explained, the IRS had concluded that cash balance plans *were* lawful.

Notice 96-8: The Internal Revenue Service announced its intention to propose regulations regarding lump-sum distributions from cash balance plans.[20] Because it contemplated the issuance of guidance on how lump-sum benefits from cash balance plans should be calculated, Notice 96-8 gave employers every reason to believe that cash balance plans were lawful.

Determination Letters: The Internal Revenue Service has issued favorable determination letters to many hybrid plans, including both cash balance plans and pension equity plans. Indeed, the Service today continues to issue favorable determination letters to cash balance plans that were not the subjects of conversions. Surely, the Service would not

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(Footnote continued)

provisions or benefits accrued under amendments adopted to comply with the Tax Reform Act of 1986); Rev. Rul. 81-12, 1981-1 C.B. 228 (addressing changes in actuarial assumptions).

[18] 56 Fed. Reg. 47,528 (Sept. 19, 1991).

[19] *See* Treas. Reg. § 1.401(a)(4)-8(c)(3).

[20] 1996-1 C.B. 359.

have done this in the past or be doing this today if it believed that these plans violate the Internal Revenue Code's age discrimination provisions.

We are currently working on the development of a legislative proposal that will address the issues relating to hybrid plans. We will be pleased to share our proposal with the Committee when our work on the proposal is completed.

We very much appreciate the opportunity to submit this statement, and hope that it will be helpful to the Committee. We look forward to working with the Chairman, the members of the Committee, and the Committee staff on the issues addressed at this hearing.

For more information on cash balance plans and pension equity plans, we invite you to visit ERIC's web site at www.eric.org.

APPENDIX

"To show how DB and cash balance pension wealth would be influenced by job changing, we posit two hypothetical workers, one of whom holds three jobs over his career, and another who remains with an employer for his entire career. . . . [In our hypothetical example, the] DB normal retirement benefit, payable as an annuity from age 65, is worth 1.1 percent of his final five-year average salary, times his years of service at termination (retirement). If the worker were to retire early, the benefit would be reduced by 2 percent per year between ages 62 and 65, 4 percent from 60 to 62, and 5 percent for retirement from age 55 to 60. Since this formula embodies an early retirement reduction rate that is smaller than the actuarially fair rate (which would be around 6-8 percent per year) , the DB plan embodies an early retirement subsidy. By contrast, the cash balance plan [in our hypothetical example] has a much smoother accrual rate, with pay credits of 4 percent per year during the worker's first decade of service, 5 percent for the next ten years, and 5.75 percent for service of 20 years or more. There were no early retirement reductions, and contributions are credited with a 7 percent interest credit per year.

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". . . . . If a young worker knew that he would remain with a single employer his entire career and retire at age 65, his anticipated accumulation in the DB plan would be one-third higher than the cash balance plan. But certainty regarding the mobility prospects is unlikely since the average American holds several jobs over his career. In fact, using data from personnel files from 65 large companies we found that only 7 percent of workers were likely to stay with one employer for their entire career. **Thus, when we compute the expected value of the two plans based on the likelihood of a worker actually staying to full retirement and receiving the full defined benefit plan[,] the expected value of the benefit from the hybrid plan is 11 percent higher than the expected value of the defined benefit plan. Beyond the expected value of the benefit, for those employees who changed jobs three times over their work life, their pension wealth from the hybrid plan would be nearly 18 percent higher than what they would have received from three different DB plans.**"

Mitchell & Mulvey, Pension Research Council, Wharton School, University of Pennsylvania, *Possible Implications of Mandating Choice in Corporate Defined Benefit Plans,* at 5 - 6 (2003) (citations omitted & emphasis added).