ESTABLISH CASH BALANCE PENSION PLANS

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Examining Cash Balance Pension Plans:
Separating Myth from Fact

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INTRODUCTION

Coverage of employees by traditional defined benefit plans has been declining for almost three decades. Initially, the shift was away from traditional defined benefit plans to greater coverage by defined contribution plans, especially 401 (k) plans. This trend was most prominent among small employers (Clark and McDermed, 1990). Beginning in the 1980s, many large employers began converting their traditional defined benefit plans to hybrid plans, primarily cash balance plans. Interestingly, the conversion to cash balance plans has generated a major policy debate while the more comprehensive shift to defined contribution plans has continued with relatively little controversy.

In my testimony today, I will address key aspects of the plan conversion process and why changes in pension plans are being made. In addition, I will review the policy issues associated with these conversions and place them in the broader context of labor market policies in the U.S. Two questions seem paramount. First, should federal regulations allow traditional defined benefit plans, defined contribution plans, and cash balance plans to continue to exist? Second, are new regulations needed to deter plan conversions for workers covered by an existing defined benefit plan or at least to compensate these workers for potential loses incurred by the plan conversion? Given the current discussion in Congress and the on-going judicial review, it is important to understand the pros and cons of each type of pension plan and to determine whether these plans help working Americans to achieve an adequate retirement income.

CHOOSING A PENSION PLAN TYPE

The value of participation in any type of pension plan is a function of lifetime working patterns, rates of growth in annual earnings, risk preferences, tax rates, and

retirement ages. Employers offer pensions to help attract, retain, motivate, and then retire workers. Both employers and employees are interested in the cost of providing a dollar of pension benefits. In a free labor market, workers search for the firm and the compensation package that best meets their preferences while companies use pensions (or the lack their of) to entice individuals with the desired employment characteristics to become part of their workforce.

Workers who expect to change employers frequently will desire jobs that have a higher percentage of total compensation in earnings and pensions that are portable. Employees who believe that they will remain with a company for their entire career will be satisfied with pensions that penalize turnover and are based on their final earnings. Companies that offer noncompetitive compensation packages will tend to have more difficulty hiring and retaining quality workers. Employers must attempt to provide the compensation package that provides the greatest value to workers per dollar of cost.

Over time, events can change the pension plan that workers and firms find most desirable. Changes in regulatory costs, shifts in labor demand, and the changing composition of the labor force will affect the type of pension that provides the highest value per dollar of cost to workers. In response, companies may (1) transform traditional defined benefit plans to cash balance plans, (2) terminate the defined benefit plan and establish a defined contribution plan, or (3) terminate the defined benefit plan and offer no pension plan. Any of these changes will have an impact on current workers and in general, a change in pension plan will make some workers better off while potentially having an adverse impact on others. My testimony today examines the three basic choices of pension plans that are currently available in the U.S. labor market. The basic

premise is that some workers and some firms will prefer traditional defined benefit plans while other workers and firms will find greater value in defined contribution and cash balance plans.

Employers offer pension plans to their employees because they help in the management of human resources. Retirement policies are integral components of employment contracts. Some individuals will seek out firms that provide pension plans and alter their careers to remain with these employers, while other workers have a higher preference for current income and will select employers who do not provide deferred compensation. Traditional defined benefit plans impose financial penalties on workers who leave "too early" and thus these firms will tend to have lower turnover rates than companies with defined contribution and cash balance plans.

Most traditional defined benefit plans also provide substantial early retirement subsidies. These subsidies to retire at ages as early as 50 or 55 have been a major determinants of retirement ages in these firms. Early retirement subsidies are one of the major differences between traditional defined benefit plans and cash balance plans and it is the elimination of these subsidies that is often at the core of the debate over plan conversions.

TYPES OF PENSION PLANS

Pension plans have traditionally been divided into two basic types: defined benefit and defined contribution plans; however, in the past decade many large employers have converted their traditional defined benefit plans into cash balance plans. These three plan types differ substantially in the manner in which benefits are determined, their methods of funding, who bears the investment risk associated with the pension portfolio, the

portability of benefits from one company to another, and the regulatory status of the two types of plans. The basic characteristics of defined benefit plans, defined contribution plans, and cash balance plans are shown in Table 1.

In general, defined benefit plans promise a specified benefit based on years of service, average earnings over the last three or five years of employment, and a generosity parameter chosen by the firm.[1] These plans typically provide significant retirement benefits to career employees but award much smaller benefits to employees who remain with the company for a shorter period. In defined contribution plans, employers and employees make periodic contributions into individual accounts for each worker. Workers often determine the size of their annual contributions and they decide how their pension funds will be invested. Cash balance plans are legally defined benefit plans but have many characteristics of defined contribution plans. The benefit in these plans is specified as a lump sum that workers may claim when they leave the firm.

Each type of plan has advantages and disadvantages for workers and for the plan sponsor. Which plan type is best for employees? The highest value plan for a worker will depend on individual risk preferences and expected lifetime work patterns. None of the three plan types dominates the other two for all workers. Some workers and firms will be better off with traditional defined benefit plans while others will have greater lifetime income if they participate in a defined contribution or cash balance plan.

The major disadvantage to workers of participation in defined benefit plans is the lack of portability of the pension benefits. Workers who change jobs frequently will have significantly lower benefits than those that remain with a single firm throughout their careers. Lower total retirement benefits are the result of final pay benefit formulas. Final

earnings for workers who leave before retirement are not indexed to prices or future wage growth. Individuals who leave a pension-covered job relatively early in their careers will have retirement benefits from their first job based on average earnings many years in the past.

A key point for policy makers to understand is that defined benefit plans systematically provide greater benefits to senior workers with long years of service while providing only minimal benefits to mobile workers who expect to remain with the company for only a few years. Advocates that argue that traditional defined benefit plans are the "best" type of pension tend to ignore the limited benefits that these plans provide to short-term workers. The more frequent transitions of working women means that they are most vulnerable to suffering repeated losses in potential pension wealth throughout their working careers.

Another disadvantage of defined benefit plans is that the method of benefit accrual and the value of benefits are more difficult to understand compared to the value of individual accounts under defined contribution plans. Managers report that workers often do not understand the difference between the current and future value of these pensions, the annual gain in value or cost associated with the plans, and the impact of job changes on ultimate retirement benefits (Clark and Munzenmaier, 2000). The difficulty in communicating the value of defined benefit plans has led many employers to conclude that their employees do not give them sufficient credit for the costs of defined benefit pensions. This implies that workers do not correctly assess the cost and value of defined benefit plans. Managers often give this as a reason for converting traditional defined

benefit plans to cash balance plans with individual accounts that are easier to explain to their workers (Clark, Haley, and Schieber, 2001).

The retirement benefit for participants in defined contribution plans depends on the size of employer and employee contributions throughout the work life and the returns to the investments made with the pension funds. Under these plans, the value of the pension at any point in time is the account balance. If contributions are made at a relatively even rate throughout a worker's career, the value of the account will grow more proportionately than under a defined benefit plan of comparable generosity. An important advantage of these pension plans is that the benefits are portable and can be taken with the workers when they change jobs.

Potential disadvantages of defined contribution plans for employees are contributions are often voluntary, workers bear the investment risk of these plans, and the benefits are typically paid in the form of lump sum distributions. Many defined contribution plans require workers to decide if they will make a pension contribution. Employer contributions may be contingent on employee contributions. Workers who are myopic may decide not to make pension contributions early in their careers and will therefore accumulate relatively low retirement accounts. In defined contribution plans, workers generally must make decisions concerning how to invest their funds. Some participants may invest too conservatively while others may make more risky choices that affect the size of their ultimate retirement accounts.

Primary policy concerns with the growing incidence of defined contribution plans include their reliance on worker decisions on when to participate and the level of contributions, the financial market risk that the worker must bear, and use of lump sum

distributions. Thus, workers may start contributing late in their working lives and accumulate relatively low retirement benefits, they may contribute too little and thus have only small retirement accounts, or they may make bad investment choices that could dramatically lower retirement benefits. The lack of annuitization also raises the possibility that workers and spouses could outlive their retirement income.

In the past decade, many large employers have increasingly converted traditional defined benefit plans into cash balance plans (Brown, et al, 2000). In many regards, the conversion of traditional defined benefit plans into cash balance plans by employers is an attempt to offer workers a pension plan that combines desirable features of both defined benefit and defined contribution plans. Cash balance plans are legally defined benefit plans but they contain many of the features of defined contribution plans that workers seem to prefer.

In cash balance plans, all qualified workers are covered by the plan and the firm typically makes all of the contributions into the pension fund. The firm is responsible for insuring that sufficient monies are in the pension account to pay all promised benefits and the plans are regulated as defined benefit plans. Benefits are specified as an account balance similar to defined contribution plans. Upon leaving the firm, the worker receives the full value of the pension account. The account grows each year from new contributions and from the crediting of a specified return on the existing monies in the account. In addition, cash balance plans tend to be more age neutral in their retirement incentives compared to defined benefit plans.

Compared to traditional defined benefit plans, cash balance plans provide the advantage of distributing benefits more equally across years of service, are easier to

explain to workers, and provide portable benefits to mobile workers. Compared to defined contribution plans, cash balance plans typically provide universal coverage to qualified workers, keep the investment risk with the employer, and offer a choice of an annuity or a lump sum distribution.

Given the differences in plan characteristics and how they affect ultimate retirement benefits, it is easy to see why some workers and firms will prefer each type of pension plan. Consider an economy where employer-based pensions were previously banned. Now let this legal restriction be eliminated and assume that firms could choose to establish a traditional defined benefit plan, a cash balance plan or a defined contribution plan. It is likely that we would observe a distribution of plan types that would reflect the human resource objectives of firms and the preferences of their workers. Plan choices would maximize the well being of workers and their employers.

ESTABLISHING NEW PENSION PLANS

Based on this analysis, it is difficult to understand why anyone would oppose limiting the choice of pension plan types that are available to workers and firms provided that they are consistent with broad national retirement objectives and federal regulations. Each of the three plan options provides value to workers; however, workers with different characteristics will benefit more or less under various plan options. Individuals who remain with a single firm for many years, especially those that stay with the company until they retire are the big winners in traditional defined benefit plans. In contrast, more mobile workers accumulate far less benefits and are the big losers in defined benefit plans.

The trend toward greater use of defined contribution plans and the transition toward cash balance plans clearly indicates changes in the composition of the labor force and the emergence of workers who do not expect to remain with the same company over their entire career. In addition, workers are now leery about accepting the implicit promise of lifetime employment that many larger firms formerly offered. In the past, many workers employed by large industrial corporations thought they had lifetime jobs and were willing to accept benefits that were based on that premise. With the recent history of significant layoffs of senior workers, many of these corporate giants have lost their traditional aura as companies where workers, even highly productive ones, can expect to spend an entire career. Thus, workers are much less willing to participate in defined benefit plans and are much more likely to demand cash balance plans or defined contribution plans.

Thus, in answer to my first question, I believe that a reasonable public policy is one that allows employers and employees to choose from among these three types of retirement plans when first considering the establishment of a pension. This range of choices should be good for employers and allow workers to select the type of pension plans that maximizes their chances of saving for retirement.

In fact, it is not the establishment of new cash balance plans that has spawned the rebellion against these plans. Instead, worker criticism and the demand for policy actions to restrict the use of cash balance plans has been the result of companies converting existing defined benefit plans into cash balance plans. It is in the conversions where winners and losers are most clearly identified. One can only wonder why critics have focused on conversions to cash balance plans while devoting much less attention to the

much large trend of terminating defined benefit plans and establishing defined contribution plans. All of the issues are the same concerning the lost opportunities to earn future pension benefits based on final earnings and how starting values or termination benefits are determined. Yet for almost 30 years, the trend away from defined benefit plans toward defined contribution plans went basically unchallenged while the more recent movement toward cash balance plans has been aggressively opposed.

Consider an economy much like that prevailing in the United States prior to 1975 in which defined benefit plans dominated. Now allow the economic, demographic, and regulatory environments to change. Other changes follow. Congress imposes significant new government regulations, there are major changes in the composition and growth rate of the labor force, and domestic employers face increased global competition. In response to these new conditions, turnover rates increase and job tenure declines. In such a changing economic environment, it is not surprising that workers and firms consider amending their pension plans. These shifts provide choices to workers just entering the labor market but also have important implications for current employees who have been participants in existing defined benefit plans. Current employees, especially senior workers who are nearing early and normal retirement ages face the potential of reductions in future pension benefits. It is these potential adverse affects that are now considered.

ACCUMULATING PENSION BENEFITS IN DEFINED BENEFIT PLANS

A defined benefit pension plan promises a stream of future income in exchange for the current labor of plan participants. When employees leave the firm or the company terminates a pension plan, the plan sponsor is legally required to pay workers the value of

all vested benefits based on the existing benefit formula, earnings to date, and their years of service. This is the benefit that would be paid when the worker reaches the normal retirement if she were to quit the company today. In the case of a plan termination, this is the benefit that the firm is legally required to pay the worker at the normal retirement age.

The present value of vested benefits beginning at the normal retirement age discounted back to the current age or the termination date can be found. This is the present value of the legally vested pension accrued to date. Changes in this value with continued employment represent annual benefit accruals. It is easily shown that the accrued benefit rises with increases in years of service, increases in annual earnings, and as the age of retirement approaches (Kotlikoff and Wise, 1985, 1989). The present value of vested benefits increases as a proportion of earnings as the individual remains with the firm and approaches retirement. A worker who remains with the firm with a traditional defined benefit plan will see pension wealth and pension compensation grow rapidly with continued employment. A worker who quits loses the opportunity to achieve this higher pension at older ages.

Most defined benefit plans offer early retirement benefits. Typically, the there is a sharp increase in the value of pension benefits when the worker reaches the early retirement age. This occurs because plans usually do not actuarially reduce benefits when they are started between the early and normal retirement ages. Instead these benefits provide a higher level of lifetime pension benefits than if the receipt of benefits was delayed until the normal retirement age. This early retirement subside provide a strong incentive for workers to retire at the earliest possible age and many employees choose to retire at that time.

Prior to reaching the age of early retirement, each additional year of service produces increases in future benefits that progressively increase in absolute value and as a percent of annual compensation. The present value of benefits is also increasing with additional years of employment. This pattern of benefit accrual is often called "backloading" and is the reason that defined benefit plans provide higher benefits to workers who remain with a single company compared to more mobile workers who change jobs throughout their careers. If the worker continues to work after the early retirement, the gain in future benefits is substantially reduced in a form of wear away of pension benefits. It is possible that continued employment would ultimately result in a decline in the present value of lifetime benefits, yet another form of wear away in existing plans.

The shift to cash balance plans has sometimes been characterized as plan sponsors reneging on their employment and pension contract. If the company simply provides workers their vested benefit as required by law, the workers will suffer the same pension loss as if they had voluntarily left their employer or if they had been laid off. It is important to recognize that the effect on the present value of pension benefits is the same whether the plan is terminated, converted to a cash balance or defined contribution plan, the worker quits to take a new job, the company lays off the worker, or there is a plant closing. In most conversions to cash balance plans, plan sponsors have used a combination of grandfathering and other transition provisions to eliminate or reduce the extent to which workers are adversely affected by plan changes.

Virtually all traditional defined benefit plans have subsidized early retirement provisions. These plan characteristics have been an integral component of company

retirement policies since the 1960s or 1970s and have been used to encourage workers to retire at specified ages. The economic expansion of the 1990s was accompanied by a slowing in the growth the labor force. The twin forces of rapid economic growth accompanied by very low unemployment rates and a relatively slow growth in the labor force meant that many firms were having difficulty attracting the desired number of young, quality workers. These same companies observed that they had in place policies that encouraged skilled older workers to retire. In response, many large companies converted their traditional defined benefit plans to cash balance plans that do not have these early retirement incentives (Clark and Schieber, 2002).

Eliminating the early retirement subsidy is an important part of human resources policies for many firms in the twenty-first century as firm adapt to an aging labor force. Extending worklife is also part of our national retirement policy and increasing labor force participation among older persons would help ease the funding problems of Social Security. Ending these subsidies is also consistent with Congressional action that does not provide subsidized Social Security benefit taken prior to the normal retirement age. One should also note that companies could eliminate the early retirement subsidies in the current plans without converting to cash balance plans.

PENSION VALUES AFTER PLAN CONVERSIONS

The level and composition of labor compensation are the products of worker preferences and the desire of firms to attract and retain quality workers. Changes in the labor market and other economic conditions can alter the equilibrium level of compensation and the characteristics of employee benefits. In recent years, there has been a dramatic shift away from traditional defined benefit plans as many companies

have terminated their existing plans and established new defined contribution plans or transform the old defined benefit plans into cash balance plans. We now turn to the impact of plan conversions on real and expected pension benefits and identify the winners and losers in the plan conversion process.

There are two major questions associated with the conversion of pension plans:

1. How is the opening balance in the new accounts for current employees determined?
2. Are current workers, especially senior employees, given an option to continue in the old plan until they retire?

When all workers are given a choice of remaining in the old plan or shifting to the new plan, there typically is little opposition or objection to plan conversions. However, this option implies that the company may have to continue to manage the old plan for as much as 40 years into the future. In actuality, most young workers with relatively few years of experience are likely to opt for the new cash balance plan or a new defined contribution plan because the expected value of participation in these plans will be greater than continued coverage by the traditional defined benefit plan. While relatively few employers have given all workers a choice, many companies have given this option to senior workers who are close to the normal retirement age in the plan. Depending on the age and service requirements associated with this option, companies can avoid most objections to the plan conversion; however, this does require the continued management of the plan for 10 to 20 additional years.

The closeout value from the old defined benefit plan and/or the starting balance in the new pension plan is a crucial component of any plan conversion. Companies can

decide if they want to roll the closeout account balance from the old plan into the new plan or start the new account balance at zero. The closeout value from the old pension is the legally accrued benefit as specified in the plan's benefit formula. This is the benefit that would be paid when the worker reaches the normal retirement if she were to quit the company. In the case of a plan termination, this is the benefit that the firm is legally required to pay the worker at the normal retirement age. Having determined the value of participation in the old defined benefit plan, firms could pay the workers this value or transfer it to individual accounts under the new cash balance or defined contribution plan. The closeout value and the start up amounts are at the heart of workers' views on whether they have been treated fairly.

Some critics of cash balance plans have argued that this form of evaluation imposes significant losses on senior workers and thus, should not be allowed. In effect, the argument is that once a firm establishes a traditional defined benefit pension plan it must guaranty all workers enrolled in this plan the right to remain in that plan until they retire as long as the company retains a defined benefit plan. Interestingly, few analysts question the right of firms to eliminate an existing defined benefit plan without instituting any new plan. Also, there have been few questions raised when companies have terminated a traditional defined benefit plan and established a new defined contribution plan. Why then has the animosity been aimed at almost exclusively at cash balance plans?

In fact, the conversion of a traditional defined benefit plan to a cash balance does impose "potential" losses on senior workers. These losses would occur if that the firm retained the pension plan and the worker stayed with the company until retirement age.

Neither of these conditions is a certainty. First, some individuals may choose to quit their current job and move to another firm. In this case, they would receive only the legally required value of their pension. Second, the company could terminate the worker due to adverse economic conditions or for cause. Once again, the worker would likely receive only the legally required benefit (of course, the company could offer a greater benefit through an early retirement plan). Third, the company could terminate the plan and not start a new plan. Here again, the worker would only be guaranteed the legally required benefit. All of these possibilities are legal and all have occurred throughout the American economy during the past three decades. It is important to remember that no company is required to offer a pension and once established, a company has the legal right to terminate the plan provided it pays all vested workers the benefits that they are legally owned.

If workers receive the amount that they are legally guaranteed, why do they feel that they have been treated unfairly? The answer follows from expectations concerning future employment, earnings growth, and the formula under the old defined benefit plan. Workers expectations are a function of the information provided by employers. Many employers may have provided their employees access to benefit calculators that show workers the retirement benefits that they could expect prior to the plan conversion. After a plan conversion, senior workers making the same type of conditional projections of future benefits would find that they can now expect smaller benefits if they remain with the company until retirement. Thus, some senior workers could easily reach the conclusion that they have been mistreated. The potential response by senior employees highlights the need for full and detailed communication with workers during the

termination/conversions process.[2] This assessment should also be a warning to companies that still provide traditional defined benefit plans that they should improve their communications to better illustrate retirement benefits conditional on staying with the firm and if the worker were to leave at various ages. Of course, no worker is guaranteed employment until the specified retirement age and there is no promise of a specific rate of earnings growth. Obviously, employment conditions have been changed by the conversion of the pension plan.

Studies by Clark and Schieber (2000, 2002, 2004 forthcoming) have shown that a large majority of workers under age 40 will ultimately have higher total benefits under a new cash balance plan. The primary reason for this is the mobility risk described earlier and the prospect of a plan termination or layoff in the future. In general, the closer workers are to the early retirement age specified in the plan, the more likely they are to be losers after the plan conversion. This is primary reason that most companies have attempted to provide some additional benefits or choice to their senior workers. However, studies have shown that many senior workers also will gain from a transition to a cash balance because of the uncertainty of future employment with their career firm.

A final issue is that much of the potential loss in pension wealth for senior workers in a conversion to a cash balance plan occurs due to the elimination of early retirement subsidies. It should be noted that a company could eliminate these early retirement subsidy by requiring an actuarial reduction of benefits at early retirement. Thus, the existing defined benefit plan could be retained without a subsidized early retirement benefit. Clark and Schieber (2002) have shown that many cash balance

conversion impose less severe reductions in benefits than if companies simply eliminated the early retirement subsidy.

DETERMINING WINNERS AND LOSERS IN PLAN CONVERSIONS

Calculating the impact of plans on the lifetime value of retirement benefits for specific workers requires a series of assumptions including: the probability that a worker will remain with the firm until retirement, the probability that the firm will remain in business, the rate of growth of future earnings, the probability that the current pension plan will be terminated at some future date, and the probability that the parameters of the current and/or the new plan will be changed in the future. In addition, we need to know the cost implications of the conversion process including: whether the firm is attempting to reduce its total pension cost or simply altering the distribution of pension benefits and whether the firm is attempting to reduce its total labor costs or restructuring expenditures away from pension contributions while increasing earnings, stock options, or payments to health plans. Another key to understanding the impact of plan conversions on specific workers is whether the company provides transition benefits to some or all of its current workers to offset potential losses in pension wealth.

Clark and Schieber (2002) examined 77 companies that converted traditional defined benefit plans to cash balance plans or another type of hybrid pension plan between 1985 and 2000. They simulated the impact of plan conversions on workers of different ages of first employment, age at the time of the conversion, and level of pay. Their underlying assumption was to assume that the company will remain in business for the working life of their employees, either the old plan would have remain unchanged until all current workers reached retirement or the new plan would remain unchanged

during this period, and that earnings growth would be unaffected by changes in the economic climate or by the change in pension plan. They applied age-specific turnover probabilities that reflected the experience of large clients of Watson Wyatt.

The results of Clark and Schieber's analysis indicate that the vast majority of workers who quit or are laid off before age 55 could expect to receive greater benefits under the new cash balance or hybrid plans compared to their continued participation in the traditional defined benefit plans. Workers who remained on the job past age 55 would expect to receive considerably lower benefits under the new plan. Obviously, older workers at the time of the plan transition are more likely to anticipate that they would still be with the company at age 55. Thus, it is senior workers that are most likely to be adversely affected by the transition and most likely to oppose these changes in the employment contract.

It should be noted that Clark and Schieber's analysis focuses solely on the mobility risk associated with these plans and ignored other risks associated with economic fluctuations such as significant declines in the number of workers needed by the company due to adverse economic conditions, future changes in pension characteristics, and the possible termination of the pension plan at some future date. Explicitly modeling these risks would in most cases reduce any projected losses associated with converting a traditional defined benefit plan to a cash balance plan.[3]

While there have been relatively few studies of plan transitions and their impact on actual workers, the basic designs of the plan types have unmistakable implications for current and future workers. Adjusting for mobility risk, most newly hired workers will be better off working for companies with cash balance and defined contribution plans.

Among existing employees, senior workers are more likely to be adversely affected while younger workers are likely to gain from plan conversions. Of course, all comparisons depend on the level of generosity that is provided by either the defined benefit plan or the cash balance plan.

The potential impact of plan conversions to cash balance plans or defined contribution plans is well known to both workers and firms. In recognition of this, many companies provide significantly higher benefits to senior workers. Such transition benefits reduce the potential loss in pension wealth associated with the plan conversion and typically, result in many fewer complaints. High quality human resource planning is a key to the plan conversion process.

In response to the second question I raised earlier, policy makers must remember that the pension system is voluntary and employers have many choices. A key concern is what is the appropriate counterfactual if conversions to cash balance plans are not allowed. If cash balance plans are not an option, firms my terminate their defined benefit plans and have no new plan, they might terminate their defined benefit plans and establish a new defined contribution plan, or them may retain the current plan but change the benefit formulas to reduce or eliminate the early retirement subsidies. Would the opponents of cash balance plans prefer one of these options? With this caveat in mind, regulations that are only aimed at preventing cash balance conversions would seem unwise and unlikely to achieve the desired results..

CONCLUSIONS

Employer-sponsored pension plans are an important component of retirement income for many Americans and a significant part of total compensation for many

workers. In the U.S., our pension system is voluntary. No company is required to offer a pension plan and no company is required to retain a plan forever. Pension regulations and the accompanying administrative costs alter the pension choices of workers and firms. A policy to preclude the establishment of cash balance plans would restrict pension choices and adversely affect American workers. A policy that would not allow companies to convert traditional defined benefit plans to cash balance plans would likely result in other forms for changes in retirement plans that would have similar effects on pension benefits of senior workers.

Comprehensive analysis of the impact of plan conversions indicates that most workers will have higher lifetime pension benefits in a world of cash balance plans (and defined contribution plans) compared to traditional defined benefit plans. Turnover and the lack of portability is the primary determinant of this finding. Senior workers who are near retirement do face the potential loss in lifetime pension benefits; however, this loss is only realized if the worker remains with the company until the age of early retirement. It should also be remembered that layoffs, plant closings, voluntary quits, firings, and plan terminations have the same impact on senior workers as conversion to cash balance plans. It is unlikely that all of these options will be restricted.

Finally, the primary reason for the loss in pension wealth with plan conversions is the prevalence of early retirement subsidies in current defined benefit plans. In the coming years, it is highly likely that firms will continue to try to eliminate these subsidies as they compete for workers. The aging population and the projected slow growth of the labor force will increase the value of senior workers to the firm. Why pay highly valuable senior workers to leave at relatively young ages only to have to search for new

workers? Ending early retirement subsidies is also consistent with our emerging national retirement policies and the need to promote greater labor force participation among older persons.

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ENDNOTES

[1] Some plans have benefit formulas that specify benefits as a dollar amount per year of service. These formulas are most commonly found in plans that are part of collectively bargained contracts.

[2] Communications with workers concerning the reasons for plan changes and the impact of these changes on worker benefits is essential to plan terminations and conversions. Clark, Haley, and Schieber (2001) and Clark and Munzenmaier (2001) examine the important role of communications in plan conversions.

[3] Samwick and Skinner (2003) focus on the differences in financial market risks and earnings growth risks between defined benefit plans and 401(k) plans. They could that 401(k) plans are preferred to defined benefit plans by all workers, except those with the highest risk aversion.

Table 1 Features of Alternative Employer-Sponsored Retirement Plans

Plan feature	Defined benefit plan	Defined contribution plan	Hybrid plan	Hybrid plan tendency
Employer contributes	Virtually always	Sometimes	Virtually always	DB
Employee contributes	Very rarely	Virtually always	Very rarely	DB
Participation	Automatic	Employee choice	Automatic	DB
Contribution level	Automatic	Employee choice	Automatic	DB
PBGC Insurance	Yes but capped	Not needed	Yes but capped	DB
Early departure penalty	Yes	No	No	DC
Benefits easily portable	No	Yes	Yes	DC
Annual communication	Benefit at end of career	Current balance	Current balance	DC
Retirement incentives	Occur at specific ages	Neutral	Most are neutral	DC
Accrual of benefits	Loaded to career end	Level over career	Level or back loaded	Mixed
Financial market risks	Employer bears	Employee bears	Shared	Mixed
Longevity insurance	Typically yes	Typically no	Not often taken	Mixed

Source: Robert Clark, John Haley, and Sylvester Schieber, "Adopting Hybrid Pension Plans," *Benefits Quarterly* First Quarter 2001.