



AMERICAN ACADEMY *of* ACTUARIES

November 28, 2005

Mr. David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G St., NW
Washington, DC 20548

Dear Mr. Walker:

I write to you on behalf of the American Academy of Actuaries¹ Pension Practice Council (PPC) regarding your recent report, "Private Pensions: Information on Cash Balance Pension Plans." Based on our review, we respectfully recommend that you amend or supplement the report to reflect the considerations enumerated below.

The study compares a typical cash balance (CB) plan based on actual sampling of conversions with a hypothetical typical final average pay (FAP) plan that the GAO indicates was developed from Bureau of Labor Statistics (BLS) data. The derived "typical" final average pay plan has a step-up integrated formula of 1.50 percent /1.95 percent. Our chief concern with the study is that, based on the best data available and the considerable experience of our council members, we typically do not find formulas that high, particularly among plans that were converted to cash balance plans.

In fact, Tables 112 and 122 of the Department of Labor (DOL) paper cited on page 59 (footnote 2) of the GAO report provide data that does not correspond with the GAO typical plan. It also uses the BLS database and reveals a mean base rate of 1.07 percent,² not 1.5 percent (and a step up of 0.52 percent). A base rate much closer to 1.07 is corroborated by a Hewitt survey of plan provisions,³ and by a Towers Perrin survey.⁴ Thus, the GAO typical final pay benefit *formula* is far more generous than prevailing FAP *formulas* — by about 40 percent for workers with earnings under the breakpoint (and 30 percent to 40 percent for workers above the breakpoint).

Part of the overstatement of the *derived* FAP benefit formula in the GAO report can be attributed to the lack of early retirement subsidies assumed for the typical plan. Plans that convert are more likely to have larger early retirement subsidies. We see no justification to understating prevailing early retirement subsidies, especially since by doing so it probably introduced distortions into the analysis.

¹ The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis, and serves as the public information organization for the profession. The Academy regularly prepares testimony for Congress, provides information to federal officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also supports the development and enforcement of actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

² While the most common percentages in Table 71 of the 2002 National Compensation Survey were in the category 1.50 percent to 1.75 percent, we have confirmed, based on conversations with BLS, that the flat rate category does not include step rate plans. However, the BLS informed us that the category does include offset plans (where the percentage recorded is the gross rate on all pay, and was not reduced to reflect the offset based on Social Security benefits). That helps explain why the 1.50 to 1.75 percent range was the most common. Another reason that the most common range seems high is that plans of smaller employers are more likely to have higher formulas, but these plans are less likely to convert to cash balance.

³ The Hewitt survey uses techniques to ensure that their typical plan (which has subsidized early retirement benefits) has a value equal to all of their plans using a standard workforce.

⁴ The Towers Perrin survey noted that GAO's *typical* plan was more valuable than 3/4ths of plans in their survey.

Page 67 of the your report notes that Table 9 of a Watson Wyatt report, “The Unfolding of a Predictable Surprise” (page 19), showed that the median converting FAP plan reduced costs by 19 percent. It was noted that such reduction is not much different from the levels the GAO derived by comparing the typical FAP and cash balance benefits. However, that Watson Wyatt figure was heavily affected by the results from the small number of plans in deciles 5 and 6 (as is evidenced by the 12 percent *increase* in costs in decile 7). In fact, page 18 of the Watson Wyatt report shows that average defined benefit costs dropped by 10.3 percent, and more important, by only 1.4 percent when including contemporaneous changes to employers’ defined contribution plans. Moreover, we note that a more recent Watson Wyatt study⁵ revealed that average cost of 55 plans that converted to hybrid plans since 1999 actually increased by 2.2 percent (5.9 percent when excluding companies that were at or near bankruptcy when they converted).

The GAO research approach was discussed in a footnote on page 60 of the report. The report further acknowledges that another approach would have been to obtain data on the plans that elected to convert to cash balance, but the report dismissed that as “outside the scope of our study.” We don’t view this as an alternate approach, but as the *best* approach. We believe that to accurately capture what has transpired in actual conversions is appropriately in the scope of this project, especially in light of the overstated FAP plan used to represent traditional plans. Even if the typical FAP plan had properly reflected actual practice, comparing two average plans does not capture the wide range of real world outcomes. For example, Table 9 of the earlier Watson Wyatt report shows the reader a more comprehensive picture. Employers with less costly FAP plans often increased their costs when they converted to cash balance plans, while employers with the more costly FAP plans more often decreased their costs when they converted. In addition, as we note above, employers often improve other benefits in connection with conversions. Watson Wyatt and Mellon⁶ studies observed this in their reports. The fact that these changes are not reflected in the GAO report causes additional concern about the reliability of the conclusions drawn.

We note that just because some employers combined their conversion to the cash balance plan with a reduction in their pension costs (e.g., Delta), it does not follow that cash balance plans are inherently less valuable than traditional final average pay DB plans. It simply means that those companies reduced their costs. It seems logical to conclude that had those companies not changed to a cash balance plan, they would have reduced costs in some other way, in many instances by reducing benefit levels or making other changes to their DB plans. Thus, we feel that the preferred way to compare traditional FAP plans with CB plans is on a cost-neutral basis, similar to the Society of Actuaries study in the October 1998 Pension Forum library.soa.org/library/sectionnews/pension/PFN9810.pdf. The GAO report also puts forth cost neutral comparisons. However, due to the problems with the FAP formula, the cash balance benefit credits are much higher than the ongoing benefit credits that employers provide. Therefore, the report’s cost neutral analysis can be misleading as well.

On page 30, the report states that in developing the FAP plan, the GAO reflected “discussions with pension actuaries, consultants knowledgeable about DB plans...” We are aware of at least two members of the Academy who discussed with GAO staff their concern regarding the level of benefits under the (at the time) proposed FAP formula before the report was issued.

We have some other concerns regarding the GAO report:

- (1) Pages 2 and 3 of the report (including footnotes 6 and 9) cite the need for better disclosure of a conversion’s effect on a participant’s benefits. While the report notes that this issue was

⁵ “Hybrid Pension Conversions Post-1999: Meeting the Needs of a Mobile Workforce”

⁶ The “2004 Survey of Cash Balance Plans” by Mellon Financial (Secaucus NY) – also mentioned in the GAO report (footnote 9).

discussed in more detail in a 2000 GAO report, the report never mentions that Congress already amended the law to address this concern in 2001.⁷

- (2) The report mentions the “wear-away” effect on page 2 and implies that it is a cash balance related phenomenon. It would have been appropriate to also mention that the wear-away concept was first suggested by the IRS in the late 1970s and is codified in Treasury regulation 1.401(a)(4)-13(c) as an acceptable approach for amending any DB plan.
- (3) We are not sure why the GAO looked just at the demographics of the 1955 birth cohort, but it would have been helpful to have a discussion on how that may have affected results.
- (4) Conversions to cash balance plans can improve benefits for workers above the age for unreduced benefits, but we did not see that pointed out anywhere in your report.
- (5) We agree that it is difficult to get good transition benefit information from Form 5500. The plan summaries often miss details that can have a major effect on the value of transition benefits. One example is how starting balances are determined, which often reflects enhancements that are not captured in summaries. Without more detailed information, one cannot be confident that all of the important elements are reflected.

For all of the above reasons, but especially our concern regarding the derivation of the typical final pay formula, we urge the GAO to revise or supplement its report to reflect the concerns addressed in this letter in order to provide the best information available in the important public policy debate on cash balance plans.

The Academy, and specifically the Pension Practice Council, has had good experiences working with the GAO over the years to raise our collective understanding of a broad range of issues and mutually to enhance the outcomes of our analysis. We look forward to continuing this relationship and welcome any questions you may have about the issues outlined in this letter. Please contact Heather Jerbi, the Academy’s senior pension policy analyst (Jerbi@actuary.org; 202.785.7869) if you would like to discuss this further.

Sincerely,

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Vice President, Pension Practice Council
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⁷ Economic Growth and Tax Reconciliation Relief Act (EGTRRA) Sec. 659 amended Employee Retirement Income Security Act (ERISA) section 204(h) in 2001.