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PLAN DESIGN FOR THE NEXT DECADE

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- o A universe of environmental forces is going to affect future benefit and compensation programs. This session will consider:
  - -- Economic forces, domestic and international
  - -- Demographics (aging population)
  - -- Regulatory and tax developments
  - -- Employment practices
  - -- Retirement patterns
  - -- Societal costs of aging
- o This session will explore how pension plan design may respond to some of these issues.

MS. ANNA M. RAPPAPORT: We'd like to begin this discussion by introducing the panel and telling you a little bit about ourselves and our perspective on pension design. I'm Anna Rappaport from William M. Mercer. I work directly with sponsors, primarily on larger plans. Diana Murray is manager of retiree benefits at FMC Corporation in Chicago. FMC is a diversified manufacturer with some 25,000 employees and 18,000 retirees. This is an international organization with a history of acquisitions and divestitures, over 40 defined benefit and defined contribution plans, and more than 50 retiree health plans. Previously, Diana was manager of employee benefits at the University of Chicago, which has about 10,000 active employees in the retirement plans it sponsors and about 2,500 retirees. She's also active in the Chicago employee benefits community, so her perspective is that of a plan sponsor who has addressed some pretty extensive redesign, planning, and administrative issues in the last few years, in both for-profit and nonprofit organizations.

David Stirling is with Conrad M. Siegel, Inc. David has about 15 years of experience in pension consulting and actuarial work, both on the defined benefit and defined contribution side. The plans that his firm works with range in size from one life to several thousand. Client's include for-profits and nonprofit organizations as well as public sector employers. David also works directly with the plan sponsors. I think his clients and mine may differ somewhat in that my clients tend to have a substantial benefits staff, whereas many of his don't. As a result, David functions in some ways as an advisor who is much closer to the client's decision-making process.

* Ms. Murray, not a member of the Society, is Pension Administrator of FMC Corporation in Chicago, Illinois.

PANEL DISCUSSION

Larry Zimpleman is an executive with Principal Financial Group involved in both defined benefit and defined contribution plans. He has about 15 years of experience as an actuary in the pension field. Larry's firm is rather unusual in the insurance industry because it still provides full service to sponsors with defined benefit plans. These plans generally encompass from one life to 500 lives. In total, Larry's group might be serving around 5,000 defined benefit plans and about 20,000 defined contribution plans.

Well, that's basically who we are. Now let's look at some of the plan design issues facing sponsors over the next decade. To set the stage a little, we thought we'd touch on a couple of the key elements in the plan design process.

On a day-to-day basis, the thing that seems to dominate all of our lives is government regulation. In terms of what we were doing last year, what we're doing this year, and what we're going to be doing next year, the Tax Reform Act of 1986 is a major issue. TRA 1986 included substantial changes in the rules for integration, coverage, nondiscrimination, and minimum participation. These changes have dominated sponsor thinking and, from the point of view of broader plan design issues, we find that a lot of people are still in shock because there are so many regulations and they change so rapidly. Thus, the regulatory climate has created a situation where people are really struggling to understand what is happening and how they should respond.

At the same time, there are some significant business issues to be addressed. Competition is a primary concern for many American employers, and mergers and acquisitions have become a key factor in the fight to stay profitable. Changes in company ownership can be a crucial issue in pension design because the retirement benefits may change radically. Downsizing is another competitive issue connected with pensions because of early retirement windows. Concern about the economy is still another issue that is sure to affect pension plans.

In the longer term, the budget deficit is likely to be a primary factor in new benefits legislation. The 1990s are surely going to bring a lot of changes, including the continuing threat of benefits taxation.

Another factor that, as pension people, we really need to focus on is work force demographics. As the baby boomers progress through different age levels, the ratio of the elderly to the rest of the population is expected to increase dramatically. At the same time, we're seeing higher fertility rates on the part of some minorities. Such a substantial change in demographics is bound to change the way employers manage their work force and provide for the employee's benefit needs. Work force projections through the year 2000 from the U.S. Department of Labor show slower overall growth in the years ahead, continued increases in female participation, a slight reversal in the trend toward early retirement, and some doubts as to whether we're going to have the right skills for the jobs that must be filled. This raises a number of questions for employers, particularly with respect to issues such as early retirement.

Now let's look at some objectives for retirement benefit planning. Typical goals in setting up pension plans have included helping to promote early retirements, encouraging

career employment, meeting employees' replacement income needs, and remaining competitive with other employers.

Diana, what do you see as the plan design objectives for the 1990s, and do you think that employers are likely to integrate planning for pensions with retiree health?

MS. DIANA L. MURRAY: Well, I think that we've come to look at pension plans as a necessary benefits component. However, I also think we're moving away from the traditional philosophy of providing benefits solely to meet employee needs. Employers are saying, "How are we going to survive?" In other words, benefits are nice if they attract good employees and if they help us in terms of promoting our business. But, if they're detracting from our main goal, which is to stay alive and generate a profit, then what should we do? A lot of employers are really looking at their benefits and saying, "Can we afford them; are they a necessary component of doing business?" Many small employers are saying, "Wait a minute, maybe we can't afford to provide benefits in the manner that we have in the past because, if we do, we will not survive." Employers are in a survival mode and they are looking at benefits as either an advantage in terms of competing with other employers or a disadvantage. If they see their benefits as a disadvantage, then they're opting to change them. I've talked to quite a few large employers in the Chicago area, and many of them are in the process of changing their benefit structures for those very reasons. For example, one unionized employer that I talked to is going from defined benefit to defined contribution plans simply because its afraid of what would happen if the company were taken over. One of the plants is nonunion, but it almost became unionized over this very issue. So the company is raising some serious questions about the necessity of its benefits. Some of the more pressing problems are: Can we do something to keep ourselves alive with these benefits? Do we need to change our design? Do we need to provide for our own safety in developing a benefits package? Employers are not looking at the individual employee in addressing these issues. Instead, benefits design is becoming a real part of corporate strategy in a way that it wasn't before. You've all read about the various negotiations that are going on, and the key components in most of those discussions are benefits. Unions are afraid that what they've gained in the past is now being taken back, while employers are afraid that what they've given in the past is going to hurt them in the future.

So the issues that we're talking about -- recession, the possibility of acquisitions and mergers, and so forth -- are playing a key role in pension design, particularly with regard to defined benefit plans. You won't see today's employers talking about providing a certain level of benefits for their employees or about how they can help them make the transition to retirement. The focus is more likely to be what will this do to us and how can we get out of this situation.

Another issue that's very frustrating for an employer is the question of entitlement. The employer feels it should have complete control over what benefits it offers employees. However, employees look at benefits as something they are entitled to make decisions about. And, of course, the government is saying you have to do this our way. So there's a real struggle going on and many employers are saying it's just not worth the hassle. Instead, these employers are looking for ways to provide benefits that are safe from the various hands trying to take them over. So you'll see questions raised such as: Are

there any plans that are safe? Are there ways we can do this that won't mean we're changing the plan every year and having to undergo all kinds of testing?

MS. RAPPAPORT: Diana, what about career employment? The traditional defined benefit plan did a really good job for a career employee, but didn't necessarily do much for the person who switched jobs frequently. Do you see that as important in the future?

MS. MURRAY: I think that many companies are just trying to stay alive. Their very existence is being threatened, particularly with takeovers and the like. Therefore, I don't feel that "career" employment is an important plan objective for most employers. I think they're looking for quality workers and they want to acquire those workers at whatever stage of life they can. Of course, there are companies that still try to promote career employment through a paternalistic benefits approach. But, most employers aren't taking that approach, and they will bring workers into their organization at any stage.

MS. RAPPAPORT: One of the things I see that runs slightly counter to Diana's view is that the investment in training people is so substantial, many companies are trying hard to try to keep experienced workers. But those efforts may or may not involve pension plans.

Larry, for many years some experts have predicted the death or decline of defined benefit plans. What do you see happening?

MR. LARRY D. ZIMPLEMAN: Before I answer your question, let me touch on some data that might be relevant. With my actuarial background, I tend to predict the future by looking over my shoulder, so one of the sources I have found interesting in this area has to do with an ongoing study the Social Security Administration has conducted for a number of years. I've seen data going back to 1972 and, among other things, the study tracks the overall rate of coverage under employer-financed pension or retirement plans. According to this study, about 48% of the full-time private sector workers were covered under some sort of employer-financed arrangement in 1972. This date has some relevance because of the pre-ERISA regulatory timing. The study was updated in 1979 and the 48% coverage rate had increased to 50%. So, from a social policy perspective, we seemed to be going in the right direction. The next study was conducted in 1983 and the coverage rate had dropped back to 48%. The latest study was 1988 and it showed the rate had dropped to 46%. So, we're now at a point where the coverage rate is actually less than it was in 1972. In my opinion, this is significant because 1972 was the pre-ERISA period, and one of stated goals of ERISA was to broaden coverage.

There's another trend that I think is important in terms of plan design for the 1990s. It's a trend away from a reliance on defined benefit plans as the primary employer-financed retirement vehicle, and the movement toward some other sort of plan -- defined contribution, profit sharing, 401(k) or the like. In 1975, the data showed that 87% of the active participants in private programs had a defined benefit plan as their primary retirement vehicle. By 1980, that percentage dropped to 83%. In 1985, it decreased to 71% and the early numbers for 1987 look like the percentage has dropped below 70%. In terms of total workers covered by a defined benefit plan, that number has been constant at around 29 million for several years. Another piece of data that I looked at

was the number of new defined benefit plans that are qualified with the IRS. If you track those statistics, you'll find that the number of new defined benefit plans peaked in 1982. The total has been dropping steadily ever since, and the number of new plans that are being qualified today is less than half of what it was back in the early 1980s.

So the answer to where we are right now is that fewer plans are being created. My sense is that the ratio of plans being terminated relative to the ones being formed is probably around 3:1. I know that in my experience and, from what I can gather, I think the overall trend is very similar. In addition, many of the terminations are among the small plans because that number of participants has remained relatively static.

As to what we will see in the 1990s, again my tendency is to try to predict based on what's happened in the recent past. Clearly, the economy and the budget deficit will have a big impact on plan design. My own sense is that we're going to see a downward trend in defined benefit plans at least until the federal government gets the budget problem under control. I don't see that happening soon and I don't hear any experts saying that it's going to happen any time in the first half of the 1990s. One of the things that has become apparent to me over the last 10 years or so is that it's a lot easier for someone in Washington to legislate changes on the defined benefits side. From a strictly political perspective, changes to a defined benefits plan simply don't bring the public outcry that results from changes to a defined contribution plan. So speaking from a political perspective only, it seems to me that defined benefit plans are going to continue to have an unfair burden put on them.

MS. RAPPAPORT: David, have you experienced the same marked decline in defined benefit plans in your practice that Larry has?

MR. DAVID F. STIRLING: Yes, we have. According to a recent interview with James Lockhart in the September 1990 *Enrolled Actuaries Report*, there are 100,000 single employer plans covered under PBGC, and the annual termination rate is 9,000 plans a year. That's a staggering number when you consider he is saying these are primarily small plans. We work with a lot of small employers who contribute from $20,000-25,000 a year to their plans. They cannot afford to pay from $3,000-5,000 a year in actuarial and consulting expenses. So yes, we are seeing a decline. Looking back 5 or 10 years, 60% of our plans were defined benefit and 40% were defined contribution. Now, about 60% of our plans are defined contribution.

MS. RAPPAPORT: That certainly seems to be the case. The smaller end of the range of employers we work with are much more likely to terminate defined benefit plans. The other thing is that the choice of whether the primary vehicle should be defined benefit or defined contribution depends on who's driving the process. If the focus is on human resources and the employer's objectives are geared to the issue of adequate retirement income, then you're likely to end up with a defined benefit plan as a primary retirement vehicle. If the process is driven by financial considerations, the result is much more likely to be the use of a defined contribution plan as the primary vehicle. Also, if you think about the issue of the financial stability, what is appropriate for a given company might very well shift over time. One of the things I find disturbing is that so many large companies have undergone changes of ownership.

I'd like to move on now to changes that have taken place in the area of plan termination and funding requirements. We're all doing more valuations -- producing more numbers -- and the rules keep changing. David, do you see that as having any effect on plan design and the way our plans are being managed?

MR. STIRLING: Rather than plan design, I'd like to address plan operation as far as what is happening. Although our topic is plan design for the 1990s, I feel that we really have to look at plan design for 1991. We are in a survival mode. What we're seeing in the small plan market is the confusion among our clients. The IRS and PBGC are busy sending conflicting messages to employers. The IRS is concerned about deficit management, and it's telling employers that too much money is being contributed to the plans. Thus, we have the new "current liability" full funding limit and we are seeing reductions or limitations of allowable contributions. On the other hand, the PBGC is concerned with the plan's financial security. It's saying that we have too many underfunded plans and we have to raise premiums. If the PBGC considered a plan underfunded, the sponsor will have to pay the supplemental premium. I think we have all seen the classic example of the plan that gets caught in the middle. As actuaries, we advised the client that it cannot contribute more because of the current liability full funding limit, yet the company had to pay the supplemental PBGC premium for "underfunding." I realize the problem has been corrected, nevertheless it was a problem We are the ones who deliver the reports to our clients. As a result, we are seen as representing the IRS which says they cannot contribute. Because we deliver the forms, we are also the ones representing the PBGC, which says they have to contribute because they're underfunded.

The IRS itself is even sending conflicting signals. The plan's at current liability, so the plan must reduce its funding. Slow down the funding and the plan falls out of current liability full funding. As a result, the plan must speed up its funding. We are finding that, full funding or not, we have to advise the client what the contribution should be. Then, we have to tell them you are close to falling out of full funding, be careful. As actuaries, we are sending our clients mixed signals, with a lot of help from the IRS. We meet with the client to establish a funding policy and develop a cost method that will provide a level funding pattern for the plan's future obligations. We hit the full funding limitation and lose control. There is no funding pattern. Clients are getting very upset with us and this continual tinkering with the law. The IRS has to establish a long-term policy, and stay with it.

The problems I've described affect more than just the operation of the plan. As Larry has shown, many clients are responding to the confusion with plan terminations, and they are not putting in replacement plans. The small employers are getting fed up, and it's the rank-and-file employees who will suffer. As far as plan start-ups, we aren't seeing them. We can no longer advise the small employer that new defined benefit plan is even a good idea because we cannot justify the expense necessary to administer it.

So, because of the conflicts between the federal and PBGC funding policies, what we are seeing is mass confusion, a lack of management control, and a growing number of plan shutdowns.

MR. ZIMPLEMAN: David has made some good points in terms of the conflicting policies that drive some of our plan design efforts. It strikes me that we're now reaching a new level of ridiculousness with some of the possible changes that we may be facing as a result of the latest budget package. For example, an earlier version, which was voted down by the House, would have increased the PBGC premium by $2 per head. The reason for the increase was to help offset the federal deficit.

MS. RAPPAPORT: Another key issue for the next decade and beyond is going to be the question of when people will be able to retire. Diana, what do you see as the retirement age trends for the 1990s?

MS. MURRAY: I realize the age trends have been going down, but I think we're going to see a reversal of that for a couple of reasons. One is the economy. We are facing some real uncertainty as to the possibility of a recession or growing inflation. Pension dollars, even those bought through an annuity, are set, and their purchasing power will decrease in a period of heavy inflation. As they face retirement, employees are asking themselves what will my pension buy in five years? What will it buy in 10 years? Where am I going to get the extra dollars to pay for what I need? At the same time, they're looking at Social Security and wondering if it will keep pace with inflation. Those are the questions in employees' minds, and most are not sure that there will be money available from either their employer or the government to help them maintain the standard of living they want during their years of retirement.

Although this is a pension session, there's also the question of retiree medical coverage. Many employers are looking at ways of either curtailing this coverage or increasing the amount that the retiree pays. At the same time employers are asking retirees to pay a larger proportion of the premium, they're implementing deductibles, co-insurance requirements, and new restrictions to limit certain types of benefit coverage. Medicare is also changing. It, too, has become a question mark over the last couple of years, both in terms of the benefits to be provided and the cost to the retiree. So, while the employer is looking at retiree medical in terms of what it will provide and what it will cost, the federal government is looking at Medicare in terms of what it will provide and what it will cost. Employees are becoming extremely conscious of their future medical needs as they see employers change benefits and shift costs. They're saying, "Wait a minute, I'll be on a fixed income. I'll have a set number of dollars and I have no idea what those dollars will purchase. What will the government provide me with in terms of Social Security, and how am I going to take care of my medical expenses?" These are very difficult questions for employees to answer and may cause a number of them to postpone retirement.

We've also seen a substantial change in the makeup of the country's work force, both in terms of the number of employees who move from one job to another (either voluntarily or because they have to) and the increase in the ratio of minorities and women in the overall labor market. By the time these individuals reach normal retirement age, they may not have a sufficient pension benefit built up, and they may want to work longer to increase their benefit amount.

All of these things are causing employees to think, "Maybe I'd better stick around a little longer, make sure that I've got enough income coming in, and a better idea of how I'm going to have to spend it." From that perspective alone, I think we're going to see more employees taking late rather than early retirements.

MS. RAPPAPORT: Do you think the employers' interest differs from that of their employees in this?

MS. MURRAY: I know there are studies saying employers will not have enough workers and will want to retain their employees for longer periods and so forth, but I don't think we're seeing that currently. Many employers are downsizing, trying to become lean and mean to make their operations run as effectively as they can with as little cost as possible. As a result, many are encouraging employees to retire early.

Employers are also looking at the per-employee cost as a worker ages. For example, particularly in manufacturing companies such as ours, the cost of a long-term disability, the cost of workers' compensation, and the cost of employee medical coverage increases among older workers. Many companies strive to keep the cost of employee health insurance at a minimum. Some companies are putting in health benefits for employees who retire before age 65 where the major part of the cost is paid by the retiree. It's easier for a company to impose that cost on a retiree than on an aging employee, particularly one who is in a union. So I think we're seeing a conflict of interests here, and until the market is such that labor shortages are critical, I don't see that trend reversing.

MR. STIRLING: Just two points on what Diana had to say. On the issue of later retirement ages because of fewer years of credited service, I think that, with the reduction in the vesting requirement and the trend away from defined benefit plans, that may not be as important a consideration as in the past. We are still seeing the total amount of credited service as a factor, but I don't think that the same amount of benefits that were lost in the past will be lost in the future. And second, the rising number of women in the work force may equate to less service at lower wages on an individual basis. However, if we're dealing with a two-income household, we may see larger overall retirement benefits. Therefore, I think we have to look at the family retirement picture when discussing replacement incomes and standards of living.

MS. RAPPAPORT: David, on the point that you made about earlier vesting and defined contribution plans, one of the big public policy issues is a concern about employees who take early lump sum distributions. There was some research published by the Employee Benefit Research Institute (EBRI) that showed a very high percentage of lump sum distributions are spent rather than saved. One of the public policy questions is whether ties should be placed on those lump sum distributions. Of course, there is an excise tax to be paid, and I would guess it's likely we're going to see a requirement for a mandatory rollover of lump sum distributions into another qualified plan. A few years ago, I did some public policy work for a client on affordability, and the issue of what happens to the money is critical in terms of whether you have a secure retirement program.

Another key issue with regard to retirement age has been the early retirement window. We've seen a lot of early retirement windows used as vehicles for work force planning. However, I think there's a real question as to what employers will be able to do with windows during the 1990s. The combination of the 401(a)(4) regulations and the way they're being interpreted will make it more difficult to do windows. The Older Workers Pension Protection Act, the bill that reverses the Betts decision, was passed by both Houses. Larry, do you know if it was signed?

MR. ZIMPLEMAN: Yes, I believe it was.

MS. RAPPAPORT: At any rate, I know that bill raises some issues with regard to windows. I don't believe the legislation knocks them out, but it will make it more difficult to do windows. And, since windows have been a big factor in encouraging early retirements, this raises new concerns for employers.

In terms of retirement plans, one of the things a lot of us have wondered about is the future of nonqualified versus qualified plans. Larry, do you see a change in the balance or roles of these plans?

MR. ZIMPLEMAN: I think of the different issues we're going to touch on, the increasing use and reliance on nonqualified plans to fulfill the retirement promise is the trend I feel most certain about. Although data are still hard to get, I think their use is growing, both in absolute numbers and in terms of the types of employers using them. For the first time in our practice, which is primarily the under-500 life market, we're seeing a reasonable number of clients who are considering and even implementing nonqualified programs. I see four reasons for this trend. Based on some of the issues that have already been discussed, I think there will be a growing need for retirement programs that cover special situations. Whether it's the use of an early retirement window to downsize a corporation or an effort to consolidate programs after a merger, I think these kinds of business activities will encourage employer use of nonqualified plans. In the past, many of the postacquisition benefit changes were handled through a qualified plan. However, the more rigorous testing the government is imposing on qualified plans makes it increasingly likely that we'll see those situations being addressed through a nonqualified program.

Second, I'm seeing such changes as a consequence of the overall redesign of benefit formulas resulting from TRA 1986. Again, our clients tend to be the smaller employers. In large measure they have plunged ahead instead of waiting for an analysis of the impact of IRC Section 401(a)(4). They are already dealing with the restrictions of maximum permitted disparity. Recognizing that this results in a shift of benefits from higher-paid to lower-paid employees, a growing percentage of these plan sponsors are instituting nonqualified programs.

Third, for a long time, the use of nonqualified programs was perhaps impeded by the fact that it is the small employer who is more likely to be bought or go out of existence. Thus, a nonqualified program didn't offer employees sufficient security. Now we're starting to see some new approaches, Rabbi trusts, and other things that provide employees with a bit more security.

And last, going back to the budget deficit, I don't think we are likely to see any growth in qualified plan limits. At best, we'll get a freezing of those limits. Therefore, individual benefits will exceed the 415 limits. In many cases, employers who feel compelled to do something will provide the excess benefits in a nonqualified form. So my sense is such plans are going to grow because, from the employer's perspective, it's the most efficient way to take care of a legitimate need in the type of "deficit" economy we're going to have for the next few years.

MS. RAPPAPORT: Any other comments?

MS. MURRAY: Well, I'd just like to say that I think that fits in with questions about the work force in the future. Good benefits will be one of the things that a company will need to attract skilled professions. If the restrictions imposed on qualified plans are too severe, many companies will switch to a nonqualified plan. Certainly, our company has nonqualified benefits for our highly compensated employees. I think we're going to see greater use of these plans as a recruitment tool and a means of staying competitive in the labor market.

MS. RAPPAPORT: I think this is one of the scariest areas because the more the retirement system shifts into nonqualified plans for management, the more likely it is that rank-and-file employees are not going to have good coverage. Instead, the pension system is going to focus on a relatively small segment of the population. I'm curious if anyone in the audience has any observations on the nonqualified issue or has seen a major shift to nonqualified plans. We hope to have some time at the end for your comments, and this is a very big issue.

A related issue to the use of nonqualified plans is that many employers have traditionally sponsored plans designed for different groups of employees where salaried personnel have one set of benefits and nonunion hourly workers have another, while union members have still a different package. Often, the nonunion hourly package would have a lower dollar value. David, what do you see happening in the 1990s to salaried and nonunion plan structures?

MR. STIRLING: Because of the obvious IRC Section 410(b) problems they cause, highly compensated employees are often written out of the salaried plan, with a supplemental deferred compensation plan used to replace the benefit they would have had. In that way, an employer can maintain its salaried plan for nonhighly compensated employees as well as an hourly plan without having discrimination problems or making significant increases in the hourly benefits. That approach is working.

MS. RAPPAPORT: Those of you who went to the regulations update saw an example of how this kind of combination plan is tested. In terms of the salaried-hourly situation, if people expect that taking the highly compensated employees out of the plan will solve the problems, is that what most people are going to do? Does anyone have any experience or comments they'd like to share?

MR. DOUGLAS K. GERMAN: The particular sponsor I'm thinking of is a very large, diversified corporation. Faced with this situation, the company just made the decision

that it was going to include all of its hourly, nonunion people in the same set of benefit structures its salaried people had always been in. The company felt it had been discriminatory in the past and wanted to correct the inequity.

MR. JOSHUA DAVID BANK: I have a situation with a couple of employers who negotiate benefits with the union employees, and then say let's give the same benefits to the salaried people.

MS. RAPPAPORT: I've been through situations where, when the company looked at its benefit structure, it seemed the only viable solution was taking the highly compensated employees out of the qualified plan because most of the salaried people were not highly compensated.

MR. GERMAN: I would add that, at the same time, we redesigned all the plans for tax reform-permitted disparity. This produced a general decrease in benefit levels that were made up through the implementation of a series of nonqualified plans. So the change wasn't quite as altruistic as I've implied. People still got benefit cuts and the company's cost stayed about the same.

MR. ROBERT J. KURAK: I'd just like to mention that there is some flexibility built into the new regulations. We've had a couple of clients with an hourly nonunion plan and a salaried plan. By combining the plans and doing the average benefits test, these sponsors were able to take advantage of some of those regulations and did not have to move any employees at all.

MS. RAPPAPORT: I think that's a really important point. The balance in the number of people can be as much a factor as the difference in the benefits. Therefore, you can't make any assumptions. What will work in one situation won't in another. Also, if you have a situation where the testing is close and the business is changing, you might meet the tests this year, then have them blow up on you later.

Another very fundamental issue is that there are going to be a number of situations where the highly compensated employees are not going to get the qualified plan benefits they got before. Social Security integration will present additional problems. Tax reform has made major changes in the rules for integration, and plan sponsors are still trying to adjust to some of them. What do we see in the market now with regard to integrated plans, and where do we see Social Security integration moving? David, do you want to start?

MR. STIRLING: Our company's approach with the plans we administer was to break them down into three categories. The first group included plans where little or no change was needed to conform to TRA 1986. The next group would maintain the same basic integration formula, but it would make adjustments to the service integration level or integration percentage. With these plans, we would present the client with a comparison: here's where you were last year, here's where you'd be this year, and here's two or three recommendations. The last and hardest group included the offsets, excess only plans, and heavily integrated plans. The process here has been a long one and is still not complete in many cases. Of the cases we handle, I am probably responsible for about

100 plans. Maybe 50 of them are defined benefit, and all but two or three have made a decision on which way they're going. This is probably a larger number than the Buck survey which showed that one third of the plans still haven't finalized their formulas or adopted the model amendments. On the other hand, with the 401(a)(4) regulations, I'm not so sure that we took the right path in getting decisions.

MR. ZIMPLEMAN: We may be in the same position that you described, David. With the number of clients we have and the types of businesses they run, we sometimes have to make decisions that, with 20-20 hindsight, we might have done differently. As you suggested, I think 401(a)(4) is one of those situations for us as well. Although frankly, it's not very practical for us to even think in terms of 401(a)(4) testing for the majority of our clients. Instead, we have been pushing them in the direction of living within the confines of maximum permitted disparity. We still have a number of sponsors who have not made final decisions but I think most of ours will do that. To the extent that there's been a shift of benefits away from folks who they feel should be treated better, as I said earlier, that's where we will see some use of nonqualified programs. So I think the small employer market will take a different direction rather than 401(a)(4) testing.

MS. RAPPAPORT: From what I've seen, a number of companies with offset plans are moving out of them. Most of the plans I work with have done initial compliance at least. Of course, a number still have some unresolved issues. But, where we had big issues to address, we generally went ahead and worked through them with the clients, who then did something. I think the offset plans are going to be retained mostly by companies that like them a lot and really want to hold on to them. The big thing is that if a company has liberal early retirement benefits, there's not very much integration left, so I see integration declining over time. What we may see are some packages that are more along the lines of a lower level of a nonintegrated benefit available to everybody, retiree medical geared to length of service because some of the people with relatively short service were getting windfalls, and a supplemental plan to provide an additional benefit to the highly compensated employees or even a more limited group. Now there's a group that gets badly hurt in that framework, and that's the group in the middle. This is a big concern but, at the same time, there may not be any good way out of this situation given the resource limitations of the sponsors. One of the things that I find distressing is that we're being asked to play by rules that aren't really all there. Does anybody else have anything to add on integration?

MR. STEPHEN D. DIAMOND: One comment you made is that offset plans are on the way out, and I guess I might have agreed as recently as a year ago. But, having done some 401(a)(4) testing, I've reached the conclusion that companies who still have offset plans may decide they want to keep them so the trend may be reversed. Based on my experience, it doesn't seem as if the rules are that difficult to pass with respect to offset plans.

On the question of whether you can get reasonable integration, I would agree with your comment, particularly if you're trying to apply the offset immediately on retirement to a subsidized early retirement plan. However, many plans apply the offset much later than the date when benefits commence. In those plans, a reasonably decent level of offset integration can still be retained. Also, in my experience, most plans have not been

integrated to the hilt, which is one reason why the 401(a)(4) rules don't appear to be quite as difficult as anticipated. In large plans, vast demographic changes are not that likely. Therefore, it seems to me that if you have a decent margin with respect to the 401(a)(4) tests, there's no particular reason to dump an offset plan if the employer is satisfied with it. There seems to be a lot of resistance to change out there, and that fact alone may be enough to cause many employers who still have offset plans to keep them.

MS. MURRAY: I would just like to support that with a personal observation. FMC currently has an offset plan. We have not made final changes despite my pushing and shoving, and one of the problems is change. We don't want to make changes if we don't have to, so we're looking at the possibility of providing minimum benefits and upping those on a regular basis rather than redesigning the plan. Recently, I talked to another large Chicago employer who redesigned its plan for the sole purpose of increasing the benefits, but still kept the offset. The reason was that the employees were comfortable with the plan design and the company didn't want to raise concerns or questions, so the plan was deliberately redesigned to be very similar to the old one. The company absorbed the cost of the increased benefits. So, from the employer's standpoint, I think personal or political reasons are often important factors in determining changes in plan design.

MR. STIRLING: I think both of your points are well taken, but you're dealing with larger employers who have that demographic margin. In the small employer market, we don't. To wait until the end of the year to do the testing, knowing that a change of one or two people may throw you out is a very dangerous approach.

MS. RAPPAPORT: A couple of additional points. I agree with the point about demographics. However, within the framework of companies who are likely to sell off pieces that represent a fair proportion of the larger organization, you can have very rapid changes in demographics. One of the things that has struck me in dealing with this issue is that there's a big difference of opinion among the practitioners in our organization. It's also important for consultants to lay out alternatives for clients without trying to impose their views or overly influence the direction the client is going. This is particularly true with the larger employers more so than small ones who may need somebody to help them figure out what to do.

Going a little further, Larry, do you see any special issues relating to integration for small employers?

MR. ZIMPLEMAN: I guess, echoing what I said earlier, I don't think there is any issue other than what Dave touched on, which is the practicality of annual testing. Therefore, we've been pushing to get decisions made within the confines of maximum permitted disparity. One final comment on 401(a)(4). I guess it's the skeptic in me, but I wonder if we won't see some changes down the road as the IRS finds plans can continue to function under the existing rules. It was clear to me that the intent with TRA 1986 was simply to eliminate offset plans. I think IRS people have said that time and again. I assume the rules were set up in the hopes of getting rid of most of them. So, even if I can get by this year, am I not going to have to face the inevitable at some point because the IRS is so bound and determined to eliminate these plans?

PANEL DISCUSSION

MR. MITCHELL I. SEROTA: I think you're right and the 401(a)(4) regulations notwithstanding, I actually tried to use the new definition of final average compensation (FAC). Of course, this does not go over very well when you're trying to relate it to an employee who's looking at final average salary less FAC and wants to know what's going on here. But the good news as far as I was concerned was that, if you use this concept of a FAC you can restructure a primary insurance amount (PIA) offset plan into a FAC offset. You'll be increasing the benefits for the lower-paid employees, but you'd be doing that anyway. And if you stay within the confines of this so-called FAC, you won't have to worry about the tests any more and the extra cost won't be that much.

MR. STIRLING: Just to summarize then, let's not be so quick to throw offset plans out. Instead, we should go through the tests where we can and increase the minimum benefits, giving us a workable solution in the larger plans.

MR. SEROTA: This was 100 life case. Is that a large plan?

MS. RAPPAPORT: I think we'll move on to the next topic. Some of you went to a session where one of the subjects was cash balance plans. Don Grubbs described the plans and told us a little bit about how they work. This is an idea that has had considerable publicity for several years. I'd be interested in a show of hands: how many people here work on or know somebody in their office who is working on a cash balance plan?

There are quite a few of these plans around, particularly among very large employers. Exactly how to handle them under federal law is still unclear. I've talked to a number of people who have tested plans under the general rule, and they believe that you can pass with the right demographics and, in some cases, with a pretty wide margin. At the same time, there's still this uncertainty. One of the issues that has come out in my conversations is that people would like more guidelines on how to handle these plans. My viewpoint is that there are situations where these plans fit very well. If you'd like to see your basic benefit defined as an account, but you still want to preserve a minimum based on a defined benefit formula, and you don't want to terminate the defined benefit plan, a cash balance plan has considerable merit. From the point of view of dealing with a work force, such a plan might be a pretty good solution, and you can change benefits as time goes on. From a design point of view, these plans definitely have a place in the spectrum of retirement programs. Whether they have a future will depend on the regulatory climate. Although the issue has been brought up, we still don't know what the regulatory people are going to do. Is there anybody on the panel with any comments on that issue? What about the audience? Do you feel strongly one way or the other, or have any comments about the future of cash balance? Some of the people in our office believe that cash balance plans are not designed to be abusive, but there are some target benefit plans that might be in practice. I think that's going to be an area to watch. I expect to see a growth in cash balance plans because I think they give employers the flexibility to deal with a lot of work force issues.

The Tax Reform Act of 1986 made the average deferral percentage test for 401(k) plans harder to pass, and a lot of people are trying to deal with that issue. At the same time, we've seen a big increase in defined contribution plans as well as substantial growth in the number of companies that had a mixture of the two. David, what do you see as the

future of 401(k) plans, and do you see employers putting more of their retirement dollars into matching contributions?

MR. STIRLING: I think that the tests are harder and the coverage has expanded, maybe cutting back the allowable limit for highly compensated employees. The main type of new plan that we are starting up is the 401(k) with profit sharing add-ons used to replace a terminated defined benefit plan. As far as what we're seeing in new plan design, the emphasis is on the matching contribution to encourage employee participation. For replacement plans, we often use a base layer (immediately vested contributions for all employees as a replacement for the lost pension benefits) and add a match, so I think we're approaching new and replacement plans differently. For completely new plans, we are stressing the match; for replacement plans, we are encouraging employers to give the base layer of contribution to everybody, then get into matching and then into a profit sharing add-on.

MS. RAPPAPORT: Complexity has been a big problem for both actuaries and plan administrators. Diana, how do you feel they interact through all of this?

MS. MURRAY: I realize there's a great deal of stress on you as actuaries in advising clients in terms of how to deal with the maze of government regulations. From the standpoint of the administrator, we're feeling the same kind of pressure. The difficulties go beyond the plan design to what we do once the plan has been designed. Like most employers, we are having a great deal of difficulty in terms of dealing with the various changes in our systems. Another problem is communicating with our employees and explaining why it seems we keep changing our minds about what we're doing. As administrators we have to be in continual contact with consultants, actuaries, and legal advisors in order to keep our plans in compliance. The complexity of the governing regulation has added tremendously to the cost of benefits for employers. Many employers are resisting further changes to their plans because of the add-on cost that you, as consulting actuaries, may not see. You may find employers clinging to something which seems totally cost-ineffective. But what the employer is saying is that we cannot handle one more change, we cannot handle one more new data situation, we don't have the mechanics, we don't have the staff, and we don't know how to explain it to our employees. So, in terms of the complexity issue, we're not going to find our way out of this maze with changes being made from one year to the next. It's a very difficult situation. I'd just like to ask you, as consulting actuaries, to remember when you go home, our job is just beginning. We need you to help us determine a way out which is not only cost-effective in terms of dollars, but equally effective in terms of structuring, implementing, and communicating. A design that may seem to save quite a bit of money on paper may send the administrative cost up uncontrollably, causing us tremendous grief in the future.

MS. RAPPAPORT: I think the cost that goes with complexity has been one of the key issues in forcing a lot of small employers out, and the 1990s are going to be difficult for everybody. Larry do you have any ideas about what small employers can do that will be effective for them and their employees?

MR. ZIMPLEMAN: Well, this is a very difficult issue. Let's look at some recent statistics from the PBGC that I thought were very telling about what has happened and

what the future is likely to be. The PBGC gathered some data on administrative expense in terms of costs some years in the past, today, and at some point in the future, and converted the information to constant dollars. I'm going to focus on the 15 life plan because of Anna's question about small employers. For 1991, the PBGC data estimates that the difference in administrative cost between a defined benefit and a defined contribution plan was about $200 per life per year. So for my 15 life plan, that's $3,000 more in administrative costs to have a defined benefit plan. That estimated cost was about $450 per person per year to administer a defined benefit program. That's approximately 35% of the contribution made for each of those 15 people. So I guess what I'm trying to say is that if you're spending 35% of the employer contribution for administrative expenses, it's pretty clear that a defined benefit plan is really pushing the bounds of being cost-effective for a smaller-sized company. That situation is not likely to get any better, which is why we're seeing more 401(k) savings programs and profit sharing plans. They're easier to administer, they sell better, and they're equally effective in attracting and retaining quality employees. If there's any money left, the small employer might put it into a nonqualified plan.

MS. RAPPAPORT: Does anybody here have any comment on the small employer issue?

FROM THE FLOOR: On another issue, I wanted to know if you think that FAS 87 is another issue that is contributing to the tendency to change defined benefit plans to defined contribution plans?

MS. RAPPAPORT: As far as the larger employers, I think it's a small issue relative to some of their other concerns. We're learning to live with FAS 87. I think where the financial people are involved in plan design, financial risk is a much bigger issue. Is it more of an issue with smaller employers?

MR. STIRLING: It definitely is. The additional charge to provide the FAS information is anywhere from $1,000-2,500. For the most part, employer's don't want the information, but the accountants tell them they must have it. So getting back to the question of confusion, we have our actuarial number, we have our PBGC number, we have our FAS number, and if we're affected by current liability, we have our deductible numbers. FAS is just one more number that the employer doesn't understand, doesn't necessarily want, but is required to have. So yes, I think that FAS 87 is affecting the small employers.

MR. CHARLES BARRY H. WATSON: I think that in terms of larger employers, FAS 87 may not be so significant for their plans in the U.S. However, when you look at multinational companies operating overseas, I think that you will find it is certainly a strong inducement to change their plans outside the country from a defined benefit to a defined contribution plan. Of course, there are other factors, one of them being the fact that the entire economy may be viewed as much more uncertain in some of those countries, so these multinational companies are trying to avoid the greater risk imposed by a defined benefit plan. Nevertheless, FAS 87 is definitely a factor.