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PLAN DESIGN: 1990s AND INTO THE 21st CENTURY

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Tough Economic Times: What kinds of pension benefit changes make the most sense in a downsizing environment? Changes in liability structures, the problems peculiar to open window programs and other severance programs financed through pension plans will be discussed.

Getting Ready for the 21st Century: Will the trend toward defined-contribution plans continue? Will cash-balance plans help stem the tide? Will age-weighted profit-sharing plans help further it? How will safe harbors and nondiscrimination rules affect plan design?

MS. JANICE P. BRICKER: I'm a consultant in Philadelphia, Pennsylvania. Our panel includes Ed Hustead, senior vice president with Hay/Huggins in Washington, D.C.; Paule Desaulniers, a pension consultant with William M. Mercer in Toronto, Canada; and Harlan Weller, an actuary with the Office of Tax Policy, Department of the Treasury, in Washington, D.C. Harlan is very familiar with the nondiscrimination regulations.

I'm going to give an overview of some demographic and economic trends which we are seeing in the 1990s and into the 21st century to prepare the stage for the other panelists. Ed will be talking about cash-balance plans, and the trend from defined-benefit (DB) to defined-contribution (DC) plans. Of course, Harlan will be discussing nondiscrimination, and Paule Desaulniers will be giving us a non-U.S. perspective, since she's a pension consultant in Canada, and she'll also be dealing with early retirement incentive programs, the types of arrangements that are offered in Canada.

I'm sure that many of you have read articles recently about the changing work force and the demographic changes through the 1990s into the 21st century. We all know that our work force is aging. That is basically due to the baby boomers moving toward retirement. What we might see in this changing environment is that our work force would expect to have different types of benefit programs offered, perhaps more health care or long-term care, which would cost more due to the aging of the work force. We might see a different mix of employee benefits. We also observe the growth of our aged and infirm retirees. There might be more pressure on Social Security and other retirement programs to provide additional benefits at retirement. One interesting statistic is that, in terms of long-term care, the number of elderly to be living alone by the year 2030 will be 30 million. We all know that more of the elderly are living away from their adult children.

We would also see a lack of skilled new entrants. Most of our new entrants into the work force over the next decade are going to be females. We will also expect to see many more minorities, nonwhites and immigrants. In fact, right now we have half of our work force made up of females, nonwhites and immigrants, and that fraction is going to be 83% of the work force by the year 2000.

We're going to have some new health risks which would be slightly different from what we're seeing today. What we're going to be seeing is increasing stress-related illnesses and illnesses due to overweight because we will have a sedentary service-related work force.

Something else which is going to be changing, and I think we've seen the beginning of this already, is the role of organized labor. Organized labor has less clout than it used to have. They're bargaining for benefits more reasonably these days. We will see a growing demand for dependent care, not necessarily just child care, but also elder-care programs. Another interesting statistic is that some families spend as much as 20-30% of their pretax income on child care.

We will probably see a new approach to retirement benefits planning, maybe more flexible programs, understanding that your retirement package is made up of a number of items such as DB and DC pension benefits, and also health care, long-term care benefits, etc. At the same time, we have many of our companies downsizing due to the economy. As a result of the downsizing, they're offering early retirement incentive programs rather than potentially having layoffs or firings. We also see companies going into Chapter 11. We see some insolvencies in the insurer market, so that people are more concerned with their benefit security, whether they will have benefits at retirement. Investment earnings are down and this impacts people in DC plans or 401(k) plans. Personal savings are also down, so that component of your benefit at retirement will be lower. Perhaps Social Security will be cut back, and what we will have is people looking more to the employer to provide a DB, and we all know what's happening to DB programs. I think an issue will be benefit portability, particularly in the condition that our economy is in right now, with layoffs occurring. People need to be able to move their benefits from one program to another. Also we're looking at other benefit reductions. For instance, companies are cutting back postretirement medical benefits to a defined-dollar approach. They're also increasing cost sharing for active employees. So there are many cutbacks in this area.

Ed is going to get into the trend toward DC plans and show you some statistics there. But, just let me say that many components go into our total compensation package and, as we can see, a number of these items are being cut back and some of them are not even provided (such as long-term care). Medicare is shifting cost from the public to the private sector marketplace, so that we see the individual picking up more and more of the cost of his retirement benefit.

MR. EDWIN C. HUSTEAD: I'm going to talk about two things, one is the DB-DC trend and what it means, and then specifically talk about cash-balance plans and what they are and how, if at all, they will eat into this trend. I think most of you are familiar with this trend you see and will generally agree with it. There was some disagreement in the late 1980s as to where we were going on this, but it's clear now what's happening. All the different studies show the same general overall trends. We surveyed about 1,000 medium and large employers who have DB or DC plans. Through ERISA and until 1983, the number that had DBs held steady at around 90% or a little bit over. Since 1983, there has been, almost literally, an annual law or regulation change or court case that has made it more and more difficult to install and to administer and to run a DB plan. That burden has been the main reason that there has been a steady and continual drop of about 2-3% a year in the number of medium and large firms that have DB plans. At the same time, the 401(k) regulations, primarily, were responsible for almost all employers now having some form of DC plan. Clearly there is still a large number, about 50%, that have both types of plans. Where they do have both types of plans, the DB plan is almost always the primary plan. So for the number of employers we surveyed who have a DB plan, that plan is the primary source of retirement income for their employees. I think there is some disagreement perhaps about the magnitude of that level, but there's a general agreement about where it's going.

As far as I can tell and as far as different studies tell, this is not primarily the effect of large- and medium-sized employers dropping DB plans. This is primarily the result of new employers coming along in the 1970-80s, and not establishing a DB plan. I think those of you who have been in this business as long as I have remember back in the 1970s and even the early 1980s when an employer said, "What type of plan should I establish?" You go down the list, "Well, here are the advantages of the defined-benefit plan and here are the advantages of the DC plan." And you worked with them through that choice when they grew to 100-150 employees.

You pointed out that it would cost $15,000-20,000 to establish the defined-benefit plan, and $10,000-15,000 a year to keep it going even with a small work force. You can spend your money like that if you want to, but you probably want to use that money to increase the deferred income for your individuals, so let's talk about the type of DC plan you should put in place.

It is, to a large part, our own fault. We have driven the design and funding of DB plans to the edge, particularly the small plans. When the policy makers up on the Hill look at how much money a small professional firm with a creative actuary can set aside, they say, "This shouldn't be happening and this is not the purpose of ERISA." And a new set of laws and regulations come in. So I think we also have to look to ourselves and the fact that we haven't done anything to try to convince Congress, convince the regulators, that we are trying to do things for employees and employees only. We are not trying to maximize tax deductions for fairly wealthy individuals. As long as they have that view, we'll get more and more regulations and the slide will continue.

Is it good or bad to get rid of DB plans? I think you have to step back and think about this. That's all we've known so we tend to think DB plans are the way to do things. Second, frankly, actuaries make money on DB plans and we don't make money on DC plans. So even if we don't consider ourselves to be biased, many people do.

When we say to Congress, "You're driving DB plans down and they're becoming dinosaurs," they reply, "So what, DC plans are good, they have portability, they create a transfer of income, what's wrong with that?" We have to answer that question.

I think if you look through the analysis, and I think I'm not being biased here, the decline is a bad thing as far as long-term income policy. First, an employer typically will put less money in a DC plan than in a DB plan. Second, there is a redistribution of the income. It's away from a long-career employee and to a short-career employee. That may or may not be a problem. Depending on how you look at it, it may be an advantage. But some of the key advantages originally seen for DC plans, 401(k)s, was that they encouraged portability and were vested. What has been found in a series of recent studies is the large majority of people are taking that distribution, paying the tax, paying the penalty, and spending the money. They're buying a car or doing something else to spend the money now. That means that instead of better affordability and better vesting, DC plans actually have worse portability and vesting because they have zero. So, the point that I think needs to be made and driven home is that combined results of this trend are to greatly reduce the share of retirement income in the future from the private sector. That means, by definition, the burden is going to go to Social Security because there is no increase in savings, and that is in the next century when Social Security already has its problems.

Having said that in general, let me look at cash-balance plans and the answer or nonanswer that they provide and what they might tend to do. A few minutes on basics and then we'll talk about the implications of it. By the way, we're finishing a study for the Pension Benefit Guaranty Corporation on cash-balance plans and what they do. It should be out soon. If you look at this and are appalled by some serious error I'm making, please tell me while it's still in draft stage.

The cash balancing plan looks a lot like a DC plan. We have an initial account balance at the beginning of the year, we credit a rate of interest on that account balance, we have an account addition, and you will have a certain amount at the end of the year. If you're five years under the plan, for instance, you're fully vested.

So that looks like a DC plan, but it is a "DB" plan. The thing that makes it a DB plan is that the employer is guaranteeing that benefit. The employer is saying that at the end of the year, I'll have a specified amount in that account, no matter how the stock market or the investment portfolio behaves. The employer is going to give you an amount based on an index. It's a fictitious account in a way. It doesn't really exist. It's not a bank statement. It's not like a 401(k) statement. But it is a guaranteed amount. So by law, by regulation, by consideration by the agencies, this has been determined to be a DB plan.

The key feature of it, the key thing that makes it different and the thing that drives actuarial cost, is the guarantee on the account and the interest rate. This is invested in a fund. The fund may be invested in 80% equities for instance. If the stock market goes through a crash tomorrow, it is the employer's responsibility to make up that loss and fund it over the long run.

When you consider a cash-balance plan, it's good to think in terms of how it's like a DC plan, and how it's like a DB plan. As far as the employee is concerned, it looks very much like a DC plan, and that's the way the benefits are usually described. The employer's cost is similar to but not the same as a DC plan.

As far as the PBGC is concerned, it's a DB plan and a premium is paid. Our general finding, by the way, is that because of the way the balance works, if a cash-balance plan shuts down, versus a traditional, DB plan, there's a much greater chance that that plan will be in a deficit position as far as PBGC liabilities are concerned because it's very close to the margin, as I will talk about later. However, because it is nowhere near as volatile as a DB plan, the total cost for any individual shutdown is liable to be much smaller than the figures you see in the paper.

As with a DC plan, the contributions and the benefits are distributed much more to the shorter-service individual. The balance is built up early in the career, and they don't build up that rapidly toward the end. They're not driven by a high-five pay base for instance. As far as considering what it will do, the amount of money it will distribute, and to what type of person, it is very similar in behavior to a DC plan.

There's a slight difference here between the cash-balance plan and the DC plan because of the way the money goes in and the investment return is credited, but basically they're very similar.

Why establish a cash-balance plan? Why not just shut down the DB plan and set up a DC plan? The DC plan, as we know, is very attractive to employees. They put much more interest and credibility in that balance building up year after year than they do in a vague promise of a complex benefit 30 or 40 years from now, even though the employer might spend more money with a final-pay DB plan. The employers typically will find that they can achieve the same purposes for lower long-term cost.

But the main driving force is the fact that a cash-balance conversion can absorb the "excess" assets. As you know, you have to be very careful defining what excess assets are. In a traditional high-five DB plan, you can say you have excess assets in a shutdown situation because you drop immediately from the projected benefit obligation to the accumulated benefit obligation. (If you don't mind, I'll talk in accounting terms, in assuming a projected unit of credit method since this is what is usually used.) But as soon as you shut that plan down, you drop the benefit obligation to the accumulated benefit obligation, and you then immediately develop excess assets if you are well funded in the first place.

In the late 1980s, the answer in many cases was to shut down the DB plan, replace it by a new DB plan, and capture the excess assets. There was a lot of controversy on that, a lot of misunderstanding, since employees don't understand what's happening; and, in 1990, there was an excise tax placed on taking that action. Going to a cash-balance plan achieves many of the same purposes. It does not recoup your excess assets right away, but it gives you a contribution holiday which allows you to recoup it over a period of years. An example is a typical final-pay plan, converted to a cash-balance plan which provides the same long-term level of benefits and the same long-term employer contribution. The dynamic there is that as soon as you convert to cash balance, you drop that projected benefit obligation down to the accumulated benefit obligation. That means you can't put any more money in the fund even if you want to; you can have a holiday. We looked at various scenarios with holidays running anywhere from three to eight years, and then gradually go back up near the level of the initial contribution. So it allows you to recover your excess assets over a period of time.

What is that all going to mean? Is the cash-balance plan going to stop this trend away from DB plans? What is going to happen? As near as we can make out, and I'd be interested in anybody who has other opinions and other facts, these cash-balance plans are popular now. They're very much focused on a certain type of employer: the large employer who can afford to go through this change and this explanation to individuals, usually an employer that's been around a long time, and an employer that has a well-funded plan. We know of about 150-200 of those plans in the U.S. today, mostly with Fortune 500 employers. Our opinion is that once you go through that group of plans and that group of employers, you will end the cash-balance drive and that will end the attractiveness of the cash-balance plan. We cannot see, for instance, a new employer with 100-150 employees deciding to put in a cash-balance plan instead of a DC plan except in very rare circumstances.

So our opinion is that this is not going to change the trend very much at all. We're still going to see a move to DC plans. We'll see some, maybe 5-10% eventually, DB plans being of cash-balance design, but not really a major change to that approach. The other thing you see is even if you did go to cash-balance plans instead of DC plans as a practice, as far as national policy, you really haven't changed anything. Cash-balance plans are going to distribute the benefits just the same as DC plans. So if our argument to Congress and to the policymakers is that you shouldn't move to DC plans because of the way they distribute income, because of their lack of portability since people spend the money, I think you have the same argument for cash-balance plans.

So the message, in summary, is that the trend will continue, and it's anybody's guess where we'll drop to. Maybe in the end, 25% of large employers will have DB plans. Some percentage of those will be cash-balance plans, but they really won't change things that much.

MS. BRICKER: I have some comments about some of the things that Ed was talking about, dealing with retirement benefit adequacy. We know that personal savings are decreasing, earnings are decreasing in DC programs, we are suspicious that Social Security will not be around, and our medical costs are going up, so who is going to provide these benefits? We always get back to that point, and I truly believe that there's going to be a resurgence of DB programs. One interesting statistic in terms of Social Security confidence levels, of those individuals who are between 18-34 years old, only 39% of them think that they will get a benefit from Social Security. Of those individuals 35-54, less than half think that they will ever get a benefit. The only group that is confident is the 55-64 year olds. So I think that we really have a problem which we have to deal with long term.

Ed and I were talking earlier about how age-weighted profit-sharing plans are the "flip side" of cash-balance plans. An age-weighted profit-sharing plan is a profit-sharing plan which functions like a DB plan. It's similar to a DB in that you can provide greater contributions for someone depending on age and compensation. You can leverage it toward your older employees, and hopefully those are the employees that you want to provide a larger portion of the benefit for. One advantage to age-weighted plans is flexible contribution levels.

What we're looking at is basically doing a cross test for nondiscrimination testing purposes. We cross test as a DB plan, and in most cases, you can arrive at a level accrual on a DB basis. Whereas, on the DC basis, you have various contribution levels, again leveraged toward your older employees. I already said it resembles a DB program. You can structure it for different savings objectives depending on what you want to provide for different times in an individual's career. You can have a 401(k) option in the program, which is an attractive feature for employees these days.

As far as administration and funding issues, in general, age-weighted plans are much simpler than DB plans on the administration side due to the less complicated accounting issues, and you have no minimum funding requirements. You have no PBGC premiums, you have no employer investment risk (which doesn't exactly fit into this category but it was an important item) and there's a potential for in-service withdrawals. So there are many features that are attractive. Age-weighted plans are generally more commonly used with very small employer groups, because the more key employees that you have in your group, the more complicated the process becomes.

Now some disadvantages. There is a contribution limit of 15%, and you can potentially get larger deductions for DB programs. You have top-heavy minimums and Section 415 limit problems in these programs. For instance, if someone is getting a contribution which is greater than the 415 limit provides, you have to go back and reallocate contribution levels. So you may go through one to three reallocation processes before you arrive at your final contribution levels. The 15% contribution limit is on total compensation for the group. You have difficulty providing past service benefits although there are some options available, but, in general, you cannot provide a significant past service benefit for your plan participants. On the nondiscrimination side . . . I'm not going to get into that because Harlan's going to be addressing most of the nondiscrimination issues, but here is a safe-harbor option. You can go through the general test, but what we see is that people are doing cross testing for age-weighted plans.

Now I'm going to introduce Paule Desaulniers who will talk about early retirement incentive programs of the Canadian variety and also give us her perspective on this issue.

MS. PAULE DESAULNIERS: I've been asked to provide you with a Canadian perspective on benefit designs for the 21st century and designs for tough economic times. I believe that there are really two trends that we can expect to see in the future in Canada, and they are: first, a continued shift from DB plans to DC plans, especially in the case of smaller plans; and some rationalization of DB plans whose ancillary benefits will be improved and benefit levels could even be lowered. Also, there will probably be an effort to involve employees in designing plans that better meet their needs.

To understand what the future may hold, we have to look at what happened over the last decade. *Statistics Canada* reports that in 1980, 55% of plans in Canada were DB plans. In 1990, that number had dropped to 40%. Now let's look at what it means in terms of members. There used to be 94% of plan members covered under DB plans, and now it's dropped to about 90%. This is not a major drop. If we turn to DC plans, 42% of plans were DC plans in 1980 and 60% in 1990. The number of participants covered under DC plans increased from 5% in 1980 to 8.5% in 1990. It should be noted that these statistics don't take into account participants in group registered retirement savings plans (RRSPs) – which are the Canadian version of your IRAs – or participants in deferred profit-sharing plans (DPSPs).

From the above, we can conclude that there's been a significant number of small plans established, and that most of them were DC plans. A number of small DB plans have also been terminated or converted to DC plans.

There is an increased prevalence of DC plans and they seem to be popular with employees. The reasons why are as follows: they're highly visible, they're easier to explain to employees, and they're generally easier to administer. For small plans, administration and complexity are most likely to be more of an issue than for the larger plans.

There are some 24,000 registered plans in Canada. A registered plan in Canada is a qualified plan here. Of those 24,000 plans, at least 8,500 are in Ontario. Some statistics from the Pension Commission of Ontario are very enlightening. Over the last three years:

- The number of plans has decreased from 11,000 to 8,500;
- 3,500 plans have been terminated during the period;
- Less than 1,500 new pension plans were set up during that period, about half as many recently as there have been three years ago;
- Finally, close to 300 DB plans have been converted to DC plans; this number includes only conversions to DC plans that are subject to pension legislation.

The trend has been slowing down in the last year or so, but it can't be ignored.

Right now, we're emerging from a decade of legislative changes, first with pension reform and now tax reform. The work force has changed significantly, and pension plans have become fairly complex with different sets of rules for prepension and postpension reform service. Many plans have differentiated between participants in different provinces because minimum pension standards vary in each province. Now, with these new tax rules, pretax and posttax reform service will have to be handled differently. It seems that we'll have to do something to streamline and simplify pension plans.

Many plan sponsors are simply fed up with the legislative complexity, and as a result, they are turning to nonregulated or less regulated arrangements. The unresolved surplus ownership issue is still scaring a number of them. Up until recently, there was no question that if the employer was responsible to fund all unfunded liabilities, he could use the surpluses emerging from the pension funds to provide plan improvements or to reduce his future contributions under the plan. Because of the significant surpluses in the plans at the end of the 1980s, employee groups and unions have started to claim that these surpluses really belong to the employees, and should not be available to reduce future employer costs. So contribution holidays could very well be jeopardized in the future.

A number of plan improvements have been granted in the past ten years without requiring plan sponsors to increase their contributions. Surpluses have been used to cover the costs of these improvements, but we're entering a period where interest rates are dropping. Will real rates of return remain as high as they were during the 1980s? Plan sponsors may find that their generous pension plans are much more costly than they expected initially, and they'll attempt to find some ways to curb further cost increases.

If interest rates keep dropping, DC plans will suddenly appear to be much less attractive than they were previously. Not only will the annual returns be significantly lower, but annuity purchase rates will be much higher.

Taxation has been a factor in designing pension plans in Canada. The limits for DC plans have been increased significantly while the bias in favor of DB plans has been significantly reduced.

How will this affect plan design in the future? Well, large employers will still probably favor DB plans as they still prove to be more efficient in distributing income to employees. In addition, in difficult economic times, DB plans are the only acceptable vehicle to provide early retirement incentives. However, we can anticipate that employers will be inclined to provide higher-quality ancillary benefits rather than higher benefit levels -- I am talking about indexing preretirement and postretirement, bridging benefits, survivor benefits, and more generous early retirement subsidies. At the same time, employers may feel that not all their employees need all ancillary benefits, and as a way to control costs, may allow employees to select the ancillaries that meet their individual needs. It's quite conceivable that we'll start seeing plans offering a number of options to meet various employee needs.

It becomes important to make employees understand that they need to participate in ensuring their retirement security. Government programs are being contracted, and employers are concerned that they may be left holding the bag. Employers may consider maintaining a trimmed-down version of their DB plans for all employees, and set up a voluntary DC arrangement as a supplement. Hybrid plans are certainly a good answer for employers as they retain some of the features of DB plans while having the visibility of DC arrangements.

If larger employers consider replacing their DB plans by DC arrangements, it will most likely be for programs with more sophisticated design. At this time, most DC plans in Canada have uniform contribution formulas. A strictly age-weighted formula will probably not be acceptable under Human Rights legislation. A small number of programs have formulas where the contribution is based on service or a combination of age and service, but as of yet, at least to my knowledge, they haven't been challenged in court.

With respect to plans for high earners and connected persons, which are our significant shareholders and owners in Canada, quite frankly there's not a lot done under registered plans. There is not a lot of room to provide benefits under a registered environment, when you think that at the end of 1992, an employee retiring at the age of 60 with 30 years of service can only get a pension of $52,000. There is a great need for supplementary executive programs.

I hope that this has given you an idea of what can be expected to take place in the future.

We now turn to tough economic times, and I understand from the speakers that we're still in for a few years. Over the last few years, we've had our share of downsizing and rationalization in Canada. From the point of view of design, the last few years have been even more challenging because the regulators were writing the rules as we were going along. Designing programs in the first part of 1991 was really a trial and error process. The real challenge was to come up with something that was appealing to the employees, affordable by the employer, and acceptable to the regulators, all of this within a very short time frame.

Downsizing involves severance packages and early retirement programs. It's important to remember that the 1980s saw significant surpluses emerge in pension funds. The economy has experienced years of real rates of return of 5-6% consistently. At the same time, inflation was being controlled and kept at a relatively low level given what we had known throughout the 1970s.

Faced with the prospect of downsizing, corporations which were already cash poor naturally turned to the fat pension funds to find relief in providing benefits. In Canada, the tax rules are such that it's virtually impossible to provide enhanced benefits from pension plans in lieu of severance payments. Pension plans can do very little for young and relatively short-service employees, and the remainder of my presentation will focus on early-retirement programs.

In all provinces, there are minimum severance benefits required under the employment standards. In some provinces such as Ontario, the statutory severance payments are waived for employees receiving unreduced pensions. Some employers have found it attractive to enhance pension benefits for older employees to avoid having to squeeze some hard-to-come-by dollars from their operating income.

The remainder of my remarks on early retirement windows will be concentrated on design issues, design constraints imposed by governmental authorities, and the impact of early retirement windows on the funding of pension plans as well as the accounting treatment of these special termination benefits.

First, let's look at design considerations: What will make a program attractive such that it meets the needs of the employees while remaining affordable to an employer? The program must be perceived as having a real value. If the program is not voluntary, the employee may be surprised when he's told that he's one of the lucky winners and that he must leave. He will be asking, why me? It is important to explain the reasons for downsizing even if they appear to be quite clear. The offer must be a fair one. The employee is giving up a lot and will expect to be compensated adequately. Some employees initially believe that the first offer that is presented is a starting point for negotiations, and that better deals can be cut. For the program to be successful, the offer must be a firm one. It must be clearly explained that there's no prospect for negotiation. All terms and conditions must be clearly spelled out, such as how long the employee has to make up his mind, and how long he has to put his financial house in order before he must leave.

From the employer's viewpoint, the staff reduction targets must be met both in terms of number of employees and in terms of the jobs to be eliminated. Is the goal to reduce the work force across the board or are specific plants to be shut down? This will have an impact on whether a voluntary or an involuntary program is to be used.

An important concern of the employer is that the program be acceptable to the legislative authorities, that is both the pension supervisory authorities and Revenue Canada. There must be a balance between the ability to pay benefits and design flexibility. Are the constraints imposed by these regulatory authorities too onerous when considering the proposed enhancements to the benefits? At times, it is a lot easier to simply top up the regular benefits and pay them from operating income.

Finally, communication of the early retirement program can be an important issue, that is the announcement of the program to employees, customers, shareholders, elected officials, and even the press in the case of the highly visible employers.

Let's turn to what you can do under an early retirement program in Canada. I will cover the requirements of the supervisory authorities from an Ontario point of view, as well as those of Revenue Canada.

The pension supervisory authorities set the minimum standards, or how much you must give if you give anything. On the other hand, Revenue Canada sets the ceiling as to how far you can go within the environment of registered plans. It is not surprising to see that the views of the regulators are conflicting at times.

Let's first look at minimum standards. Under the Ontario Pension Benefits Act, there is no specific requirement dealing with early retirement windows. As a result, the Pension Commission of Ontario (PCO) has a lot of administrative discretion in approving the programs. Their initial concern, up until the middle of 1991, was that plan sponsors financing their benefits out of surplus assets were inappropriately distributing surplus to a small proportion of their employees. This really translated into a peculiar situation. If a plan was in a surplus position, the program was not acceptable to the PCO unless employers made a special contribution to pay for these benefits. On the other hand, Revenue Canada prohibits any contribution to be made where a plan is in a significant surplus position. If a plan had an unfunded liability, an early retirement program that would undoubtedly worsen the plan's financial condition was acceptable.

How was this possible? Well, the Ontario Act has some obscure rule regarding gradual and uniform accrual of benefits, which must have been written to prevent back-loading of pension benefits to avoid the vesting rules. The PCO invoked this rule whenever it suited their purposes. You ended up having a number of very dissatisfied plan sponsors . . . and consultants . . . some of them very vocal.

The result was that, in the early part of summer 1991, the PCO, finally understanding that enhanced early retirement benefits really were in the best interest of plan members, which they are supposed to protect, came up with administrative guidelines. While they are only guidelines and subject to change at any time, at least they provide plan sponsors with a reasonable framework to develop their programs.

These guidelines essentially allow plan sponsors to recognize additional years of service for employees who retire within a given period of time. Alternatively, more generous ancillary benefits can be provided during a window period, that is, bridge benefits or early retirement conditions.

These benefits must be available to a class of employees, with a reasonable age and service requirement. This means that you cannot provide benefits only to, say, executive vice presidents or employees hired on July 15, 1963 . . . . The window must span over a reasonable period of time, generally at least one month.

All plan members must be advised of the early retirement program, for instance, through posting of the program in accessible locations or through an announcement in a newsletter. Employees who are within the eligible class of employees must receive an individual notice.

Finally, the window should not adversely affect the solvency position of the fund or, if it does, benefits must be funded. As you can see from the above, these new requirements are not too onerous.

Let's turn to Revenue Canada. It is important to understand that the thrust of the new tax rules was to provide all Canadian taxpayers with a comprehensive limit for tax sheltering of retirement savings. Essentially, Canadian taxpayers are entitled to tax shelter up to 18% of their income each year for retirement savings subject to a dollar limit. This comprehensive limit applies to both employer-sponsored programs and personal savings. Under a DC arrangement, employee and employer contributions as well as any forfeitures, if any, are applied against the annual 18% limit. Under a DB arrangement, $1 of pension accrual is converted into a $9 contribution regardless of the participant's age or of the bells and whistles attached to the pension (indexing, early retirement subsidies, survivor benefits, etc.).

The system allows for some carry-forward of the unused tax sheltering room. However, any plan improvement that increases the employee's pension must be reported, applied against any room previously carried forward and may even reduce an employee's room in the future. This applies to improvements in respect of years of service after tax reform, this is after 1989 for most plans. Under this new system, deeming years of service is not practical and is prohibited except under very specific circumstances.

Generally, the new rules provide unreduced benefits as early as age 60, after 30 years of service or when the sum of age and service totals 80 points. For public safety occupations, unreduced benefits can be provided roughly five years earlier than under the normal rules. Before that, early retirement benefits must be reduced by no less than 3% a year. Bridging benefits can be provided before age 65 to a maximum of government benefit levels. In 1992, government benefit levels were at a maximum of $1,000 a month. These maximum bridging benefits can be provided to employees who are 60 and have 10 years of membership. If an employee has less than 10 years of membership, the maximum is prorated. If the benefits are provided before the age of 60, the maximum is reduced by 3% a year.

Most Canadian plans do not provide early-retirement benefits as generous as those permitted, and there is often room to enhance benefits within the prescribed limits. Furthermore, the new rules apply only to service after 1989, and there may be some latitude to provide prereform benefits for employees not yet at the maximum pension levels.

However, there are situations where additional relief is required, especially in times of severe economic conditions. Special downsizing benefits are provided under the new rules. The conditions are very stringent and very few plan sponsors have been able to avail themselves of these special rules. These rules allow recognition of up to seven years of additional service to a limit of the projected service to age 65. They also allow the more generous early retirement conditions applicable to public safety occupation to be used.

In order to use these special rules, an employer must submit a downsizing program where it is expected that there will be a net reduction of his work force in the locality where the benefits are offered. The net reduction must be of the total work force, and not just in respect of plan members. There must be a net reduction of 10% of the work force, and not less than 50 employees. This means that if the program is voluntary, the employer must commit to terminate enough employees to meet the net reduction requirements if the early retirement offer does not find enough takers. Needless to say, this requirement has not been very popular.

In addition, the program must be broadly applicable and nondiscriminatory. It must not benefit mostly highly paid employees. Benefits cannot be commuted, and the pensions must start within two years of the introduction of the program. This is basically what the regulators will allow us to do in terms of early retirement programs.

Let's turn to the impact of these special benefits on funding and accounting. From a funding perspective, these benefits are subject to the normal rules. Generally, an unfunded liability must be funded over a period not exceeding 15 years. However, if there's a solvency deficiency, the deficiency must be eliminated over a period of not more than five years. Solvency is a measure similar to a termination value where market rates of interest must be used; employees vest immediately regardless of their service; and future salary increases are eliminated.

The difference is that the present value of the amortization payments expected to be paid in the five years following the valuation date is added to the market value of assets and compared with the solvency liabilities. This determines whether there is a solvency deficiency. Solvency deficiencies are generally funded over five years.

Let's turn to the accounting side. In Canada, Section 3460 of the *Canadian Institute of Chartered Accountants (CICA) Handbook*, dictates the accounting treatment of pensions. This is the Canadian version of SFAS 87. Section 3460 was silent on the treatment of early retirement windows. Some sponsors adopted the view that, because these programs would reduce their long-term labor costs, the costs associated with the early retirement programs should be amortized. That view was often accepted by their auditors. However, in January 1991, the Emerging Issues Committee of the CICA issued guidelines in which the financial impact of these downsizing benefits must be recognized immediately. Some sponsors do not realize that even if the additional benefits do not require any additional cash outlay, nevertheless, there will be an element of expense, which may be quite significant and which may further reduce their already depressed reported income.

That really sums it for downsizings and early retirement programs in Canada. Now I will turn it over to Harlan Weller.

MR. HARLAN M. WELLER: First, I'd like to say that I am speaking on my own behalf here, not the Department of Treasury. I wouldn't like to see six years from now a court case quoting me and making some sort of decision on that basis. I'm going to reverse the order of what we've had so I'm going to first talk about the early-retirement windows, and then I'll get into some of the DB-DC type questions that were discussed first. I'd also like to start off by noting I hope that the early-retirement windows and the downsizing issues are really not the kinds of issues which we're dealing with in the 21st century. It's depressing to think that ten years from now employers will still be trying to cut back on employment, but that's a separate comment.

The regulations under Section 401(a)(4) and Section 410(b) are about a year old now, and they provided a mechanism for testing discrimination in DB or DC pension plans. Essentially, the mechanism said look at the level of benefits being provided under the plan and look to see whether that level of benefits is being provided to a proper cross-section of highly compensated and non-highly-compensated employees. So, in the case of an early-retirement window, you would look to the group of employees who are eligible for the early retirement window under the terms of the window, such as those employees who might be 55 and have ten years of service, whatever the specific plan provision calls for, and that group of employees would need a mix of non-highly and highly-compensated employees which has some relationship to the mix of the employer as a whole. We've heard from a lot of people that this doesn't work very well, that a typical group of people near retirement age, the kind of people who are getting the early retirement incentive program, tends to weigh more heavily toward higher-paid people. Therefore, there's a richer mix of highly compensated versus non-highly-compensated than the employer has in total. I don't know that that has persuaded us a whole lot. The baseline that the government is looking at is that this is a valuable benefit that's going to people and, therefore, it should go to a proper mix of highly paid people and nonhighly paid people. From the government's perspective, the basic break which you get in an early retirement window is the fact that it can really be a temporary provision, and there's no requirement that it stay in the plan. It's an analysis under Section 411 of the code as opposed to analysis of the 401(a)(4) and 410(b) coverage and nondiscrimination rules. In the regulations, there was a minor break provided for windows that recognized the potential for a problem in which the window spans two different plan years.

Generally, the nondiscrimination is tested on a plan-year basis, and you might well have the situation in which you have a window that spans two plan years. Let's say at the start of the window it was a reasonable group of highly paid people and non-highly-paid people eligible, but imagine that the nonhighly paid people were the first ones to leave and they left in the first year, meaning, when you looked at it in the second year, only highly paid people were eligible for the window. In that unfortunate circumstance, the regulation gives you a break and essentially says test it only in that first year and don't worry about what happens in the second plan year, assuming that you haven't changed the window, of course.

Another comment that we've heard from people who have windows is that a typical program provides for a possibility of reserving someone from terminating after the close of the window. The typical situation you hear is the window's available to everyone who is 55 and 10 (or whatever the eligibility is) but a special rule which says the VP of Finance or Personnel or Human Resources Manager, or the person who's really critical for this whole process, can't leave immediately, he has to stick around through the end of the window and maybe even a month or two months after. That's one type of scenario.

Another scenario might be (it may be completely unrelated to the personnel or the function) you have three people who are the only people in the company who know how to do a particular job and all three of them decide they want to "jump out the window," they want to take the early retirement incentive. Sometimes the employer reserves the right to say: "No, one or three of you, two or three of you, or all three of you have to stick around long enough to train your successors in this job." So we've heard a lot of feedback about the tight definition of an early retirement window in the regulations, and we're examining that issue as to whether the definitions can be modified to permit a limited kind of extension of the window for bonafide business reasons.

I'm going to talk now a little bit about the cash-balance plans and the DB-DC quandaries that employers are stuck with. Traditionally, there was a very clear line between DB plans and DC plans. You went to an employer and you explained to them, if you do a DB plan, this is the result: you'll typically have a weighting of your contributions toward your long-service employees, you might have higher contributions, you'll control the investments. There's a whole litany of items. To contrast, if you had a DC plan, you'd have variability of contributions, you'd have equal contributions at all ages, etc. Now there has been, through creative practitioners, a split in the benefit distribution issue from the plan design issue. We've seen the age-weighted profit-sharing plans, which, although they are DC plans, provide a distribution of benefits that mimics what a DB plan does and vice versa. You have the cash-balance plans, which are DB plans, in which the distribution of benefits mimics the DC pattern. So you no longer are really forced to be "pigeon-holed" in one type of plan design or another, and this has created some interesting questions from the regulators. In the 401(a)(4) regulation, we did spend some time setting up a safe harbor for cash-balance plans.

Now, the cash-balance plan safe harbor represented the government's first effort to actually define what these things are. Cash-balance plans were first invented back in 1985, and, although they all share the same kind of appearance to the employees, the one that Ed showed earlier (in which you have an account balance and accumulation), the underlying way that is implemented in a DB context has differed from designer to designer. Sometimes it wasn't clear how those plans were complying with some of the statutory requirements, such as Section 411. The proposed regulations, or the final regulations under 401(a)(4), set out a very specific model of something which we call the cash-balance plan, which had a particular way of complying with Section 411 accrual requirements. Now, there may be, in fact, other ways of complying with Section 411 accrual requirements, but we took a very conservative point of view in how we designed that plan that we showed as a safe harbor, because we wanted something which unquestionably satisfied the requirements.

Certainly the moment it becomes a safe harbor, as released by the government for purposes of Section 401(a)(4), it has implications under Section 411. So in that sense, we did not push the edge of the envelope in terms of designing this plan in applying to Section 411. For example, one thing that we did not do is give any kind of comfort to the problem or maybe we even made the problem worse by identifying how to apply the Section 417(e) interest rate requirements. For those of you who aren't familiar with all the details, there is a requirement in the Internal Revenue Code that you use a particular interest rate for cashing out lump sums, and there is a ceiling on the interest rate that you use for these lump sums set by reference to what the PBGC provides. Obviously, the lower the interest rate, the higher the lump sum. In the example that Ed provided, there was a 7% interest credit. Maybe that was a fixed number in the plan document, so that those future interest credits would offset the interest rate that you need to use to discount in order to determine a lump sum, and would determine that, when a person received a lump sum, the amount of their lump sum would be their cash balance account, what they've always seen in the DC sense. That may not be so easy to do, and the regulations, in fact, provide that you need a reasonable projection of what the interest rate would be, especially in the context of an index-type interest rate, where it's tied into T-Bills or bonds or whatever. There's a requirement that you project what those interest rates will be, and then you apply the statutory discountings to determine the lump sum. You may very well end up with a lump sum value which is greater than what you've told employees their account balances are.

We'll note that one other piece of comfort in the 401(a)(4) regulations was how do you apply a requirement in Section 411 that benefits do not decrease as a person ages. If you have a cash-balance plan, in which you have an accrual, which might be 5% of pay in a DC sense, and you included in the accrual the effect of all future interest credits, then the closer you are to normal retirement age, the fewer years for those future interest credits to compound, and effectively you have a smaller accrual because you are closer to normal retirement. The preamble to the Section 401(a)(4) regulations said that this will not be deemed to be out of compliance with Section 411(b)(1)(H) merely because you have a shorter period of the interest credits.

Let's talk a little about what Ed was discussing: When will policy makers see what is happening to DB and DC plans and what could you do if you think that DB plans need to be emphasized some more? Again, these are my own thoughts: DB plans have really been somewhat of a headache the last 10-12 years, and not all the headache has come from the government back to the employers, but the employers created headaches for Congress. Also they fear problems with the PBGC. There was a recent front-page article in the *Washington Post* discussing the PBGC. Not very many people have heard of the PBGC, but Congress is worried about the solvency of the PBGC and the question of whether it's the next savings and loan crisis.

There have been questions of reversions in the late 1980s. The employers terminated plans, reverted excess assets, and that's been a very big headache for Congress. They hear from employees who complain "they stole our money." We followed up if the reversion (or the termination) had been accomplished by buying annuities from a shaky insurance company. You have the small-plan audit, another source of headaches. Well, people in Congress right now probably aren't feeling very charitable toward the DB world. It's been more of a headache than anything else. However, I think they recognize that there is a role for DB plans in delivering retirement income, and, in particular, the ability of the DB plan to provide substantial retirement income to those people who stick around with an employer without necessarily spending dollars on short-termers.

I agree with Ed's comment about how it really does direct the retirement income where you need it. I think that is balanced by the Administration: The Administration pushes a little bit more on the "empowerment" side. That's a common word that we've heard in the last couple of years, in which there's a belief that the best kind of policy is to hand people the money in terms of a DC plan and let them invest it themselves (the opposite of a paternalistic kind of view, where the employer is responsible for the retirement plan). In any regard, whether it's a choice of a DB or DC plan, you always have to keep in mind that these programs are, in fact, very costly from the government's perspective.

Under the Budget Enforcement Act, any change in the law that takes place gets scored as a money loser or money gainer from the government's perspective, and the qualified pension plans are the biggest single possible place to gain money. The congressional representatives who are under pressure for additional spending on new items, or additional tax relief in the next few years, are going to probably be looking at the benefit side again, as a honey pot, to try to cut back on deductions and potentially be able to support new initiatives. I think the best way for actuaries and employers to protect the system, if they believe that's important, is to demonstrate that the dollars being spent on retirement plans are being spent in a broad-based manner, that they're going to all employees. I think probably it would be helpful if employers were focusing more on annuity-type plans as opposed to lump-sum-type plans. That's a different kind of division, rather than DB-DC, but I think, from a policy point of view, Congress is probably going to be happier with plans in which the money stays in the system and is doled out as people retire, as opposed to a system that creates lump sums, turned over to employees to do with what they want.

MR. HOWARD YOUNG: I have two comments, rather than questions. One is on this last point and it also deals with what Ed Hustead raised, the DB-DC policy position point of view. I think that, as actuaries, we ought to recognize there are some other influential players in this debate and, in particular, the economists. I tend to read a lot of their literature, and even recently we had an article in *Contingencies*, written by an economist. They tend to view, according to my reading, DC plans as preferable to DB plans partly because of this empowerment argument, partly on the argument that it's more neutral in terms of the impact on compensation, and my only point is that they tend to be very influential with policymakers.

My second comment is on the question of people's attitudes toward whether Social Security will be paid. I think it's our job as actuaries to substitute facts for impressions, and we ought to really emphasize that Social Security benefits have always been paid on time, there's no prospect that they will not be paid on time, and that's not true for the private pension side.

MR. HUSTEAD: I've heard the economists say that as far as the person spending the money on the car, well, they got the value just as in retirement, so it's the same difference, and that's a little difficult to deal with, but as you say it has to be recognized.

MR. DAVID LANGER: I want to comment on Harlan Weller's bringing up the tax expenditure concept. When I first heard about it, I called the Committee on Taxation to ask why they did not recognize offsets against the tax expenditure. For example, they estimate that the tax loss to the government is around $60-62 billion. Harlan, is that about right?

MR. WELLER: I think it's about $50-55 billion, if I remember right.

MR. LANGER: Okay. Now this is a gross number, and I mean gross in a couple of senses, I think. They do not reflect the fact that, in the same fiscal year that they estimated this, they're going to collect about $200 billion (the taxes are $200 billion on pension payments), and, if you assume a 20-25% tax bracket, you're talking about $40-50 billion they receive right there. Second, the money goes into investments through the various pension funds and serves to enhance the economy. This, in turn, generates corporate and individual income which in turn generates more government taxes. Third, from a human point of view, the people who have pension plans will have more money at retirement, have that as income and they will not be dependent on relatives and also the government. From the government side, they will also not have to spend as much to help these people.

MR. THOMAS MORE ZAVIST: Would you say that every DB plan with a lump sum normal form is a cash-balance plan?

MR. WELLER: Not at all.

MR. ZAVIST: Which ones would not be and why would they not be?

MR. WELLER: I would say that the basic definition of the benefit is in terms of whether the present value of what you accrue in a year tends to be level at all ages, is the determining factor of what makes a cash-balance plan a cash-balance plan. If you are just taking a final-average pay plan and offering a lump sum, then the same kind of pattern in which the people near retirement, the long-service people, are going to get huge accruals, will translate into huge annual additions in the cash-balance sense, and that's, I think, different from what people think of as a cash-balance plan.

FROM THE FLOOR: I want to take a little bit of issue with something Ed said which I think leads to the implication that large employers are terminating DB plans because of legislative and regulatory provisions. I think it's clearly true the small employers have done that in droves, but I think the extent that large employers have terminated DB plans has been driven almost solely by financial issues. I don't believe they are concerned about $15,000 a year in annual cost as small employers are. I think perhaps the growth in DC plans by new large employers is because these have been entrepreneurial-based organizations, and also perhaps, as our Canadian representative suggested, we've had unusual economic circumstances in North America for the last 10 years: excellent stock returns and high real interest rate returns, which make DC plans look extremely attractive. I think the real question is, if we get into a period of time where we don't have good stock returns, and where, instead of crediting interest on GICs at 8-9%, we are crediting at 3%, whether those DC plans will appear nearly as attractive.

MR. HUSTEAD: I'm afraid I must not have been clear, because I agree with you. I thought what I said was that there is very little evidence that large employers have been dropping DB plans in favor of DC plans. It is a fact that small employers, many of which eventually become large employers as you say, never installed it, never even considered a DB plan when they're growing because of the cost as well as the other things you mentioned. So no, I don't see any evidence of large employers dropping the plans, and I certainly wouldn't think that the expense would enter into their judgment.

MR. RALPH J. BRASKETT: I have a question for Harlan Weller. Is there any chance that the playing field at the regulatory legislative level will be leveled by either doing something to increase the Omnibus Budget Reconciliation Act (OBRA) full-funding limit or cut the DC maximum addition back from 25-15%?

MR. WELLER: It would be very dangerous to predict what Congress is going to do, but I think it's less likely that the OBRA full-funding limit will be raised from the 150% as it is that you do something in the Section 415 annual limit for DC plans. I don't know that the 25% necessarily will be cut back, but I wouldn't be surprised if the freeze is maintained for a few more years on the $30,000.