RECORD OF SOCIETY OF ACTUARIES
1995 VOL. 21 NO. 3A

DOWNSIZING AND PLAN DESIGN

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Recent economic developments have led many companies to reduce their workforce through layoffs, plant closures, and early retirement windows. This panel discussion will examine the impact of this activity on the pension plan, and explore design options that have been used in conjunction with downsizing.

MR. STEPHEN A. WHITE: In this session, we will talk about coordinating the business goal of downsizing the workforce with a company's employee benefit plans. We will concentrate on the U.S. environment.

I would like to introduce the speakers for this session. Anna Rappaport is a managing director of the William M. Mercer Chicago office. Anna has 35 years of experience in the actuarial profession, with concentration in the retirement and health practice areas. She specializes in large clients and has a particular interest in business and demographic changes. She has served as a Vice President of the Society and is currently a member of the Board of Governors.

Paul is also with William M. Mercer in Chicago. He has 16 years of experience in the actuarial profession, with concentration in retirement and investment consulting. He is a part-time faculty member at Loyola University, where he teaches human resources and industrial relations. Paul also specializes in large clients, but his concentration is in university plans and not-for-profit clients.

I am a pension consultant with Milliman & Robertson in the Seattle office. I have been in the field for about ten years. I do have some experience with downsizing and early retirement windows, but I would not say that I am an expert in the area.

Just as an introduction, we would like a quick show of hands as to how many in the audience are practicing in the retirement area. [Virtually everyone.] Is there anyone representing a plan sponsor as opposed to being a consultant? [A few plan sponsors.] And how many have had direct experience helping a company achieve goals in the downsizing area? OK, so we have quite a bit of experience in the audience.

Our agenda will begin with definitions and some of the reasons why companies downsize and some of the general approaches to downsizing. Then we will evaluate benefit plans as they can be used to support downsizing goals and the special compensations and incentives they can provide. After that, we will get into the meat of the discussion, looking at what is typically provided in these plans and the issues that need to be considered. We will be looking at severance plans; we will obviously concentrate on defined-benefit plans, and we will also be looking at retiree medical and other postemployment plans. We will look at the financial implications of using benefit plans when downsizing and at the applicable laws and other considerations. We will also consider what the pension plan might look like after downsizing. We have some case studies that we will present, and we will also be asking you if you have case studies or other experience you would like to talk about.

To begin, here are some of the names (meaning essentially the same thing, but with some subtle differences) for the business goal we have called downsizing: downsizing, rightsizing, reduction in force (RIF), early retirement window, open window, early transition, and reengineering.

What causes companies to decide to downsize? Usually there's more than one reason; they include market conditions, the need to become more efficient to remain competitive, the need to replace outdated skill sets, increased outsourcing with the concurrent decreased need for workers, consolidation, and plant shutdowns.

There are two basic ways to achieve downsizing: on an involuntary basis and on a voluntary basis. Involuntary, obviously, means the employees do not have a choice. This can be done with or without a special compensation package. You cannot offer an early retirement window, but you can offer a severance package. Voluntary means that employees are offered the choice, usually involving an incentive, of leaving the workforce. In this case, you typically might offer an early retirement window. We will get into these in more detail as we go along.

Just a warning about early retirement windows or any voluntary package: If you offer a voluntary package, you may be surprised by the results. It could backfire; the people you most want to leave might decide to stay and the people you can least afford to lose might decide to go.

MS. ANNA M. RAPPAPORT: I'd like to start by asking you to think about whether a qualified plan makes sense. We frequently have clients that will say, "I'd like to talk to you about an early retirement window," or maybe, "Charlie down the street did an early retirement window and we think that might be a good idea." And before we say, "What should we do to build this early retirement window?" we want to ask the question, "Does a qualified plan make sense? Is this really the right thing to do?" And sometimes the answer is, "Yes, a qualified plan, early retirement window is a great idea and will work for you." But often it will not, and we find out that it doesn't make sense, and that some other things make much more sense. So, we want to start by focusing on the people. Who are the people and what are their characteristics?

You might say, "I have this business. I need 50 people out and 75 people are eligible for early retirement." That sounds like a good candidate for an early retirement window, right? Maybe, maybe not. We need to ask if the people that you need out are specific people. What are their job functions? If you pick randomly from your workforce, will you get a group that will accomplish your business needs? If so, an early retirement window might be just fine. But it might be that you need 75 people out, including 30 of one group and ten of another group, and it all doesn't match up. If you don't think it through, you may end up keeping the people you need out and losing the people you need to stay.

If you have people leaving that you needed to retain, you haven't accomplished your goal at all. A possible nightmare in this situation is that they take the window, but you need them and bring them back as contract employees and pay them more money. I had a friend who retired, and for five years after he retired he was working for a temporary agency. Where was he working? The same place he worked before he retired. Same desk, same work, but he was getting his pension and health benefits as a retiree, and higher pay as a contract employee. That's not what you want when you downsize. You need to look at the workforce, and you need to think about it very carefully from a human resources point of view. You need to ask the question, "Will a window accomplish my goal, and will the people likely to pick the window accomplish my goal?" And if a window won't accomplish your goal, then what kind of a program will?

There are other issues we need to think about in terms of qualified plans. The financial issues are very important. Is there a surplus in the pension fund? If there is, then you may be able to use the pension fund to help pay for the window. In the long run it doesn't save any money, but in the short run, the same reasons that might be leading you to downsize might be leaving you short of cash. Even if the pension fund isn't overfunded, the fact that you can pay the cash over a period of time is a consideration.

There is also an accounting issue, and we find that this is often a surprise. Many of you find that when you tell your client that the full cost of an early retirement window is an accounting charge for the current period, they are surprised. This is an important issue. It can kill plans for a retirement window right upfront.

Then there are legal issues in qualified plans. Paul is going to talk about those. But first let's consider the issue of past practice and precedent, both from an accounting point of view and from a human resources point of view. What happens if we offer early retirement windows sporadically—one this year, another three years from now, then one again in six years? We build a history of them. From a human resources point of view, employees come to think, "Well, I am thinking of retiring, but they're probably going to have another early retirement window. I won't retire right now, I'll wait." Then what we've done is we have managed to enrich the pension plan because people are waiting to retire when a window is available. We have managed to clump retirements, which creates disruption in the workforce. So we have done a number of things that can be destructive. In addition, if we've done it often enough and with enough regularity, we may very well reach the stage where, from the accountant's perspective, this is all just part of the plan. So we need to be careful in designing windows. That's not to say that they don't work well. We have been working with a client recently that has probably had five or six windows in the last few years. But they haven't been general windows; they have been carefully targeted at specific business units and very small groups, and the client has been very pleased with the results.

From a financial point of view, we have a number of tools to work with. In qualified plans, we can enhance the cash retirement benefits or offer lump-sum payments. Paul is going to talk about these options. Other approaches, and these can be done in combination, are salary continuation using severance pay plans, health and welfare benefits continuation, outplacement (packages for people not eligible for retirement commonly include a combination of these three). We can increase the subsidy for retiree health insurance, or, if we don't offer retiree health insurance, we can offer it during the window period. In fact, you could have a window that is nothing but early retirement health benefits. Combinations are very common, and we can think about all of these approaches when designing a reasonable package.

Severance pay plans are defined in Internal Revenue Code (IRC) Section 457(e)(11). Payment is not conditioned on retirement, and the total amount paid must not exceed two times annual pay for the year preceding termination. Paul reminds me it's not limited to $150,000. Payments must be completed within 24 months, except when in connection with a limited program of terminations, in which case payments must be completed within the later of 24 months after termination or 24 months after normal retirement age. Payments are made from the general assets of the employer—which means paying immediate cash; it's very different from drawing from the pension fund. Reporting requirements are limited, and there are no nondiscrimination issues.

If we think about most severance programs we are familiar with, they are likely to give six months to a year of pay for employees with considerable service. In some cases it's less. An employee with a year of service might get a week, two weeks, or a month, depending on employment level. We can see that severance pay plans work very well in many termination programs. And these programs can be voluntary or involuntary, by the way; you can pick the people, target a group of people, or let people volunteer. From a business point of view, in many cases, severance pay plans are a much more effective tool in terms of accomplishing the business goals, particularly when you do not have a group of targeted people, or when you can draw randomly from the workforce. Paul is going to tell you about defined-benefit plan requirements and issues and options.

MR. PAUL B. ZEISLER: No great surprise, we can use the defined-benefit plan to provide enhanced retirement benefits to people who retire during a specified period; I know most people have done this. Let's talk about the enhancements that can be provided. It's very popular, of course, to provide additional years of service for calculating benefits. For example, we can offer an additional five years of service for benefit accrual purposes for those retiring during the window. We can also reduce or even eliminate the early commencement factors that might otherwise apply. To continue the example, not only will we treat you as if you had five more years of service for benefit accrual purposes but we will also treat you as if you were five years older. The factors that would otherwise apply can just be eliminated for employees who are under 65.

Social Security bridge payments to make up the payments an individual can expect to receive from Social Security commencing at age 62 or at age 65 can be included. As part of the incentive package, if you retire during the window period, we will temporarily provide you with the estimated amount of Social Security benefits you will receive at age 62 or age 65, paid until your age-62 or age-65 Social Security benefits begin.

Other temporary annuity benefits are common. For example, we will provide you $300 per month until you reach age 65 to help you cover the cost of purchasing health care coverage, either through the company plan or elsewhere as may be appropriate. This is perhaps the direct analog to the defined-dollar approach to retiree health and may be appropriate if we have surplus assets in the defined-benefit plan.

We can also talk about flat-dollar increases and benefits. For example, if you retire during this period, we will give you an extra $100 a month, or $500 a month, or $1,000 a month, or whatever the amount might be. This could be appropriate, for example, for a group of hourly employees or a group of employees within a close range of salaries prior to retirement. It is possible in fact to provide salary continuation benefits from a defined-benefit plan. It doesn't always work terribly well and it is quite expensive, but Anna and I have a client who did just that. They eliminated the early commencement factors and made the benefits for the first year equal to the individual's salary immediately prior to retirement. This in fact is one of those horror story cases to which Anna alluded earlier, where many people ended up being hired back as contract employees. So for at least the first year after retirement, they were being paid at least twice what they were getting immediately before they left—not a particularly good deal for the employer, but a great deal for the participants.

We can define the group to whom window benefits are provided in terms of age, service, and employment classification. We might specify, for example, everybody 55 or older with ten years of service, or (in a hospital environment) all nurses 55 and over with ten years of service. We can make it a combination of factors or any individual factor. And again, no great surprise, we can take advantage of surplus assets to cover the cost of these enhanced benefits. For accounting purposes, as Anna mentioned earlier, we must recognize the full cost at the time individuals elect to retire under the program.

Without such surplus assets, it still may be advantageous to use a defined-benefit plan, and this applies to the funding. We can spread the cost of the program over a period of up to 30 years if we don't have a surplus. But again, we must recognize the full cost for accounting purposes at the time individuals elect to retire under the program.

It is important to note that we can allow long-term disability (LTD) offsets. The pension can commence at either the employee's election or when the employee reaches the later of age 62 or normal retirement age. And this just makes good sense if you have an individual who is disabled at the time you offer a program of early retirement incentives. You are able to say to that individual, "Look, you're welcome to avail yourself of these incentives." We don't want to encourage double dipping, and this provision allows us to avoid just that.

Let's talk more about the legal requirements and the nondiscrimination rules that apply. Coverage is probably the right place to start. First, if the plan satisfies the ratio percentage test, meeting the coverage requirements should be easy. The reason is, for testing purposes, window benefits are treated as being provided to current employees only and the test does not consider the level of benefits. That's all well and good. Many plans of course do not satisfy the ratio percentage test. If we're averaging benefits, then compliance can be affected. This will depend on the level of the window benefits provided and the composition of the group to whom the benefits are offered.

With IRC Section 401(a)(4) nondiscrimination testing, things get a little more complicated. In most cases, general testing will be needed to show that benefits are nondiscriminatory in amount, unless of course we have a safe harbor plan and both the window and nonwindow groups satisfy IRC 410(b) and the window benefits meet the safe harbor requirements. There are many conditions, but as a practical matter many plans will satisfy these requirements and we will not need to do general testing.

Nondiscriminatory availability is generally not an issue unless we have an otherwise unavailable payment form offered. A good example of this is where an employer offers a traditional defined-benefit plan with monthly payments at age 65 but provides that the people who go out during a window period can take their benefits as lump sums regardless of the amount. In such a case, things are a little more complicated. We will have a currently available requirement that will be satisfied if the window group meets the ratio percentage test or the nondiscriminatory classification test. The effective availability test can be satisfied as long as the window group doesn't substantially discriminate in favor of the highly compensated, based on facts and circumstances. Again, this seems to be simple to show in most cases. I tried to come up with a group that might not do it. You have to work, but I think it is possible.

There is a nondiscriminatory timing requirement which is satisfied, again, if the window doesn't substantially discriminate in favor of highly compensated employees and is based on facts and circumstances. If you only communicate the availability of the window to highly compensated employees, you are going to run into problems; also communicating to highly compensated employees well in advance and then the rest of the employees only a few days before the window closes is also a problem. These examples might well violate the nondiscriminatory timing requirement.

Final point, and this is extremely important. Anna alluded earlier to situations where companies offer windows year after year. If you keep a window open for more than a year or put one window on top of another window so they run back to back, you may run into anticutback problems if you eliminate the window at some point in the future. Anything that is open for more than a year is generally going to be subject to IRC 411(d)(6). You need to be very careful about how you discontinue window benefits that have been open for more than a year.

FROM THE FLOOR: Does the nondiscrimination availability apply to the group that's eligible for the window or the group that takes the window?

MR. ZEISLER: To the group that's eligible.

MS. RAPPAPORT: Paul, I have a question for you. What if you can't quite pass a nondiscrimination test and you pull out a few of the most highly paid people who are eligible and do something different for them? Can't you usually offer a window to most of the rest of the people even if you have to slice off the top?

MR. ZEISLER: I think that in many cases if we find that the window group is going to include too many highly compensated people, we can separate it into two groups. For the group of non-highly-compensated employees, we can keep the window in place and provide the benefits from other sources to the group of highly compensated employees. That works pretty well in the for-profit sector; it can be problematic in the not-for-profit sector because of the 457 rules, which are going to produce some adverse tax consequences for that group. There are some ways around it, most notably the creative use of severance pay plans.

A second case, and this is probably less common but may become more so as time goes on, is where we have a group that's substantially highly compensated. This is for all intents and purposes a management cutback—a window for management-level people. In such a case, a qualified plan may be a pretty poor choice just because of all that's entailed in meeting the nondiscrimination rules. You would be better off to look to nonqualified forms of payment, which will give you much greater flexibility in defining the group and none of the nondiscrimination rules to contend with. Other comments or questions about use of defined benefits?

MR. JOSHUA D. BANK: Could you summarize any particular differences in nondiscrimination and in any other issues with regard to government or municipal versus corporate plans?

MR. ZEISLER: Well, I think, very broadly, the issues you're going to contend with are the same that apply to not-for-profits. Under 457, if we provide benefits to a group of highly compensated people, they're going to be taxed on the value of those benefits whether or not they can receive them all at the current time. There are many restrictions there. Section 457 limits the first $7,500, which is fine; but beyond that we're going to be subject to all of the taxation problems.

MR. WHITE: I have a question, Paul. In order to keep the whole package at a safe harbor, the window benefits have to satisfy the safe harbor. Can you go back to the typical window benefits and outline which would be safe harbor and which, if any, would not be safe harbor?

MR. ZEISLER: Let's look at additional years of service for calculating benefits as an example. We have a safe harbor plan and we provide a few additional years of service for calculating benefits; that should keep us in the safe harbor environment.

Reducing or eliminating early commencement reduction factors is another example. If we have an integrated plan, and it is integrated to the limits, and we start eliminating those factors, then we're going to have some issues; we no longer have a safe harbor plan.

Social Security bridge payments are another example. As long as we satisfy Committee on Uniform Securities Information Procedure (CUSIP) requirements, we're going to be OK. Other temporary annuity benefits should not present problems, provided we have a good group. And that assumes that we are not providing integrated temporary annuity benefits; but in most of the situations that I've been involved with the past few years, when these have been provided, they have been a flat-dollar amount intended to cover the cost of health insurance. Flat-dollar increases obviously present no problems. Salary continuation, however, is more likely to create problems. These problems tend not to be simple nondiscrimination problems, but sometimes backloading problems.

MR. WHITE: We will return to Anna now, to get into the retiree medical issues.

MS. RAPPAPORT: We talked about there usually being a combination of benefits. When we're talking about retiring before 65, retiree medical is a crucial issue in people's willingness and ability to retire before 65, regardless of whether or not there is a window. So this is a big red flag. If there's no early retiree medical available and the employer starts talking about a window, one of the big reactions at the first meeting is, "Well, what about retiree medical?" Most people will not feel they can retire without retiree medical. If there's no retiree medical plan offered, the window will probably have a low acceptance rate. If the pension early retirement eligibility is lowered, then the retiree medical eligibility will probably need to be lowered too. Depending on how the two plans are set up, that may happen automatically.

There are two key issues regarding medical coverage for early retirees. First, there's essentially not much of an individual marketplace. There is some, but very little. Those who are sick or have a medical problem and who retire early and don't have access to the company medical plan probably can't buy medical coverage at all unless they're in a state with a purchasing pool. For those who aren't sick, individual coverage is going to be very expensive. So retiree medical is an area to watch carefully. Second, as states undertake health reform, the alternatives for early retirees to buy into individual arrangements will vary considerably from state to state. And, in fact, depending on the way coverage is rated in a state, such coverage might be a pretty good deal for the early retirees. Once state coverage is available, the question becomes whether people have enough money; it's no longer a question of access. If other coverage is not available, it is an access question.

Even if your window does not change the early retiree medical, you might take a big hit in terms of retiree medical costs, because you didn't change the plan, you changed the early retirement rates. With a larger group of retirees than expected, we're going to have additional costs for years until Medicare. Unlike pension benefits, the expensive years for retiree medical plans are the pre-Medicare years. So you might have per-person costs as much as five times as high until the retirees are Medicare eligible. This also is likely to be treated, if it involves a significant number of people, as a curtailment under *Financial Accounting Standard (FAS) 106,* with the increased liability immediately expensed unless offset by an unrecognized loss.

From the perspective of total cost, the accounting cost and the long-term cash cost for retiree health could be as big or even bigger than the pension cost. Retiree medical cost may be a very significant amount, so it is a major issue to keep in mind. I think it's probably relatively rare today that people forget about retiree medical when doing windows, but it was not rare five or ten years ago.

There are also some special consulting challenges. In most cases today, I think the same people at the client organization are responsible for both pension and medical, or at least they talk to each other. So there's not likely to be a case where someone wants to talk about a pension benefit and when you tell them there is a problem in connection with their retiree medical, they say "I can't talk about that. I have this little corn patch that I am in charge of, with a fence around it; retiree medical is over there." We don't see that very much any more.

A retiree medical issue that doesn't directly tie to the qualified plan solution is one where people go out before they are eligible for early retirement on some sort of severance arrangement. They do not have access to medical. They are in the 45–50 age range and receive some severance, but they have trouble finding a new job; these people basically lose their retiree medical eligibility, and this can be a big issue.

There are issues for other postemployment benefit plans as well. Generally, severance arrangements provide for some continuation of health and welfare benefits after termination of employment. You have to provide a COBRA plan. Usually there's more than a COBRA plan provided in terms of what's being paid. And if the medical plans are self insured, you may not discriminate in favor of highly compensated employees without adverse tax consequences for the highly compensated.

So these are the main issues we want to raise in connection with medical coverage. Now I would also like to ask for comments, ideas, or questions.

MR. BANK: I'll extend my question about government to foreign subsidiaries of U.S. multinationals. Can you briefly describe any nondiscrimination or design issues that you've come across there, especially with some foreign economies going down the tubes lately? Let's say PepsiCo or a company like that is substantially reducing their workforce in a Latin American country. Have you been involved in anything like that and are there any special issues there?

MR. ZEISLER: I think, very broadly, the special issues with which you're going to have to deal can be broken into two areas. One is plans for locals, which will be covered under local law. And the other is plans for expatriates and the extent that they are covered under the U.S. plan and subject to those rules. That tends to be done largely because of the pay level of the people with whom you're dealing. This will broadly be handled through a nonqualified plan.

MS. RAPPAPORT: And you would also have to be very careful of termination indemnities in each country that you're working with. It would be important to have someone who has worked in each of those countries involved in the decisions and evaluations.

MS. JOAN BOUGHTON: Are there any *FAS 112* implications for the postemployment benefits?

MS. RAPPAPORT: There certainly could be *FAS 112* implications, depending on the type of benefit involved. And they should be searched for to make sure that there are not significant amounts or liabilities in other benefits.

MR. ZEISLER: Let's spend time on the financial implications of using qualified plans as a source of downsizing incentives or other special compensation for window retirees. As we mentioned before, the funding probably breaks down into two cases, the first of which is the plan with significant surplus assets. As a result of providing special window incentives, we will have less surplus; it's as simple as that. The second case is the plan that is not in a surplus position. Here we can amortize the cost over a period of up to 30 years. But in the one case, the onset of required contributions will be accelerated; in the other, the amount of required contributions will be increased currently.

From an accounting perspective, there are two pieces, one of which we mentioned earlier: there is the need to record the full cost of the special incentives at the time people accept them. The second is that while we will have lower service costs, we will certainly have higher interest cost; and, in most cases, the higher interest cost will far exceed the reduction in service cost we otherwise recognize for *FAS 87* purposes.

There's also an implication in terms of the PBGC variable rate premiums. The provisions of special early retirement incentives may very well put the plan in a position where variable rate premiums apply; or if such premiums already apply, it will exacerbate the situation, particularly following the Retirement Protection Act of 1994. That can become pretty expensive. Again, it's very important to take a look at all of these issues on the front end. We have had clients who liked the idea of this until they saw the implications two, three, five, or ten years down the road. And in fact, we strongly recommend a plan that's in a surplus position, if rich early retirement incentives are going to be offered, to do some forecasting 5, 10, 15, or 20 years ahead to see just what this is going to mean in terms of required contributions—when they'll arise and at what level. It's similar for expense.

Finally, and this is very important, to the extent we have a plan in the surplus position or we don't and we're making contributions currently, providing special incentives may limit our ability to do so again in the future for another group, or improve benefits for the remaining employees. The latter may be more important than the former. It's very important to look at what this is going to mean, not only in terms of the window that we're offering today, but what it's going to mean down the road.

MS. RAPPAPORT: I'd like to add a comment to that. I think this applies both to windows and also to grandfathering when you're changing the plan. It's very easy at the time you're doing something like this to spend a large sum of money that you don't have, and then to be very sorry later. So help the client think through the question, Do I have the money to pay for this?, particularly if the decision-making group includes either some of the people that are affected or their close friends. You need to be careful in terms of the impact on the business. We had a question on municipal and government agencies and I think there is an issue there also. Is the government going to have the money to fund the program that you're doing, and what are the consequences on the taxpayers later?

MR. ZEISLER: In terms of other law beyond the nondiscrimination rules that will apply for qualified plans, it seems appropriate at this point to mention the Age Discrimination and Employment Act of 1979 and also the Older Workers' Benefit Protection Act of 1990. There's not much to be said here, but what's important is that the Older Workers' Benefit Protection Act codified that we cannot cut off a window for people beyond a certain age. We cannot say everybody between 55 and 62 with ten years of service may go out under the window but nobody over 62 can. I don't think this has ever been standard practice; although one occasionally encounters a client who says, "We'd like to just offer it to this particular group." I think the Older Workers' Benefit Protection Act makes it clear that you can't.

There was a great deal of concern at the time the Older Workers' Benefit Protection Act was passed that it would make it difficult to offer unduly rich incentives, and in fact we had a long discussion with a law firm in Chicago about whether that in fact was precluded and whether you could in fact run into difficulties by offering incentives that were deemed too rich. In fact, the preamble to the Congressional Report on it makes it clear that the intent was never to limit the incentives that can be provided, but rather to limit the way in which an employer might otherwise coerce people to retire.

There are many other considerations that are very important at the time you consider establishing a window and designing its provisions. One of them obviously is collective bargaining agreements. There are many arrangements under which the union has most favored nation status. To the extent you provide special retirement incentives to a non-union group, you may end up automatically providing them to the union group. If you're not aware of this and the client hasn't apprised you of the terms of the collective bargaining agreement, it makes good sense to take a long look at that before any commitments are made. Know what you're getting into.

It is very important to determine what employment contracts say, particularly if we have an executive group that might be covered by the window. You may find that you cannot do what you want to do, given the terms of employment contracts.

Employee communications are critical. Again, part of this is for purposes of meeting the nondiscrimination requirement. You'll run into difficulties if you communicate informally with the highly compensated but not with their nonhighly compensated counterparts. But more broadly, any program of early retirement incentives is perceived as a program of workforce reduction or cutbacks. In order to maintain morale, it's important that you communicate what you're doing, why you're doing it, and what the organization plans to do in the future. Again, this can provide a great deal of stability and a great deal of comfort for the people who are not affected.

Now, where there are programs of involuntary termination (reductions in force), survivor guilt is fairly common. The people who remain, the people who were not asked to leave or were not told that their jobs were being eliminated, feel fairly bad for the people who left. And here again, it's important to communicate. It's important to talk to people about why some jobs have been eliminated and others remain, about where the organization is going in the future, and what the expectations might be for their jobs.

Conversely, where you have programs of rich incentives that are offered on a voluntary basis, there's often some resentment on the part of the people who were not eligible for such incentives or who did not accept them for one reason or another, but it's more prevalent in the case of people who were not eligible. I am not sure that there's an easy way around this one. Wherever you have a cutoff, somebody is going to fall on the wrong side of it. On the other hand, communication will do a great deal here, particularly to the extent that it discusses peoples' prospects for the future.

Finally, waivers will not always protect you, but certainly there is some measure of protection available if you have the people who accept early retirement sign them. We recommend getting a law firm involved very early on to draft the necessary waivers, to review them, and to make sure that things are being done according to the book. This will be important in the event of a challenge or a suit later on.

MS. RAPPAPORT: I'd like to add one thing about the use of qualified plans. I think there is a definite preference to use qualified plans to minimize the number of people that you have to lay off and downsize. And I think that's a very laudatory thing to do on the one hand. On the other hand, if it means that you end up with the wrong people going or having to pay too much, it can be a bad business decision. So I think it's very important to look carefully at the window and at the preference for a window (because a window is humane and it doesn't involve having to do terminations) and ask if this is going to be right for the business and if it is going to work. If a window is not the best answer, do not do one as a way out. You will still have to do the terminations and you may very well end up having to rehire some of the people, so care is very important.

MR. ZEISLER: Now let's look into the future. You've designed a window program for your client or your client has, one way or another, downsized; what do we do after the fact? In many cases, organizations offer early retirement incentive programs or implement reductions in force that are successful, but make no changes to their plans. We think it makes more sense to think about what's going to happen down the road. Let's remember the client who undertakes a reduction in force because there are many people with outdated skills, I think what this means is that the workforce for the future is going to be very different from the workforce of the past. We need to look at the characteristics of that workforce going forward to determine what that workforce may need. In many cases, it may not be the same as the program that worked so well for the workforce that has now been reduced. It's very important, for example, to look at the age of the people we're going to have in the future. If a program of early retirement incentives or reductions in force has reduced the average age from, say, the mid-40s to the mid-30s, you might very well conclude that the type of plan you need is different. If you had a traditional defined-benefit plan, you may now have an environment in which a cash-balance plan or a defined-contribution plan will work a little better. Take a look at this. There are obviously some great opportunities here to work with clients to tailor programs to meet their needs going forward.

Equally, and Anna may have something to add here, the organizational culture may change. And the changes in culture may drive plan design as well. Organizations are changing pretty rapidly right now, and it seems reasonable to except that their benefit plans should change with them.

MS. RAPPAPORT: In that regard, I think there are several important issues. To what extent is the culture going to shift to one where pay is based on results? And if pay is based on results, the retirement plan approach that makes sense might be one that is more heavily linked to results as well. Also, if the culture is one that has a certain set of expectations built into it about job tenure and if this notion of "the new employment contract" becomes more common, long-term job tenure may be replaced with "as long as there's a job here that works for both of us, you'll have a job." This creates a situation where having a retirement plan that's geared to rewarding long service is viewed by many people as quite unfair. I was with a client in the last few months who said, "You know, we've always had a culture here of long-term employment. And we still have a culture that's based on long-term employment, but we do a large number of acquisitions. And nobody around here will admit it, but I know that when we do an acquisition, about one-third of the people in the combined business unit are probably going to have to go. And I want to know, if people have to go, that I am square at the end of any day." His concern was about people in their 40s and people who will soon approach retirement eligibility. Will they have to go; Were their plans serving their employees well? He wanted very different types of retirement programs. Now it hasn't happened yet, but it is a big cultural-change issue. So a new kind of plan might be in order.

There is, by the way, a special kind of window that we haven't talked about but that is in line with this. If you have a radical change in the plan, you may have permanent grandfathering, which is not a window. You might also have some sort of temporary thing (this is particularly true with retiree plans, but it could be on the qualified plan side as well). It could be a retiree health thing where if you go out within a certain number of months, you get the old deal; if you go out after that period of time, you don't get the deal anymore. Of course, qualified plan benefits are protected to an extent that accrued retiree health is not. But I would say that is very much an issue. What kind of a program should you have after the change? Depending on what's happening in the organization, that's equally important to the transition, in fact much more so usually.

MR. ZEISLER: We mentioned earlier that it's important to manage participants' expectations. Earlier we talked about this in the context of an organization that has offered several windows over the last few years and the peoples' retirement patterns are reflecting that. Say an individual who is thinking about retirement today says, "I am going to wait until the next window is offered. I am not going to retire without this special benefit that most of my cohorts received when they retired." Managing the expectations of participants is important. Most clients will try to say in their window communication that the organization does not intend to offer such a window again in the near future, or there are no plans to offer such a program again, or there are no plans to offer such a program in such and such a period in order to avoid this pattern of retirements following a pattern of windows. But I think, more broadly, to the extent we have a change in workforce and we've offered early retirement incentives, changing the plan design can in fact be a way of avoiding this pattern where retirements follow windows. If you had a traditional defined-benefit plan, and, if a program of incentives caused the average age of your workforce to decline significantly, and if you were to move to a cash-balance plan, you might in fact avoid that problem. You might avoid the situation where people say, "Well, they're just going to offer another window." A cash-balance plan is, in many cases, a less obvious candidate for providing early retirement incentives, although certainly that can be done through such a plan.

Also, and I think this comes back to Anna's point about the change in organizational culture, the objectives of the new organization can be very different. If before we had a culture in which we wished to foster career employment and we liked the idea of people staying until retirement and now we have a culture where we don't think that's important or in fact we'd like to discourage people staying until retirement, plan design changes may be appropriate in order to encourage that and to support the organization's new objectives. Here again, some sort of plan that provides for earlier accrual may be better suited to the new organization's needs.

MS. RAPPAPORT: One of the things that people are all looking at today is the defined-benefit/defined-contribution question in terms of the new organization. One of the big arguments for defined-benefit plans that we must not forget is that they do give us the flexibility to do windows and to help manage the workforce.

FROM THE FLOOR: Do you see much in the way of retraining as an alternative or in addition to windows to partly overcome one of your objections for having to rehire people or as another thing to consider? And what problems might you encounter?

MS. RAPPAPORT: A very interesting question is what about retraining rather than doing windows? For one of the projects we worked on, retraining was the key issue. In this case, the key issue was that the client wanted to keep the people who could be successfully retrained and let go of those who couldn't. The conclusion was reached that a window was just the wrong thing to do. I think retraining is a big issue, and it's getting widespread recognition in workforce management. In this case it came up at the point of discussing the window. It's coming up an awful lot in workforce management, but not necessarily at that point. The big Chicago area human resources organization's whole spring conference this year was on the new employment contract. Many topics focused on keeping your skills up to date so you're marketable inside or outside of the company. It also focused on getting people to rethink themselves, even though they are not actively thinking about leaving your employment. We must also get them to think about continuously marketing themselves inside your company as well. Training is getting a very different kind of focus and emphasis. I think there has also been research and different experiments that show that some people retrain and adapt well and some don't. I think some adapt only after they're displaced, which is unfortunate. So it's a difficult issue. Within our own profession, we can think about technology as an example. I dare say if we went around this room on the issue of technology in our field, we would find that the extent to which people have adapted to it is tremendously wide ranging. The implications for different people are tremendously different.

MR. LIANGAN LIU: After the downsizing, we were debating within the company whether the culture of the organization changed, whether the cultures of the employees to the employers changed, whether the turnover would change, and whether the early retirement patterns were changed. We also, as the actuaries, considered whether we should change the turnover and the early retirement assumptions within the retirement plans. I'd like your comment.

MR. ZEISLER: There are many questions there, but let's start with the corporate culture. One of the ways you might start is by looking at mission statements (many organizations don't provide them, but oftentimes there are informal mission statements in most publicly traded organizations' annual reports) and start looking at the changes in those statements over a period of time. See if you in fact get a sense of what the organization is doing. You can even more easily look at the sort of services and products it provides to see if those are changing over time.

In terms of the employer's attitude toward its employees, you can get a sense of that from senior human resources executives and other senior management. In some cases, one-on-one interviews can be helpful there. For employees to get a sense of their commitment to the employer and whether that's changed, focus groups can be helpful. We think that's a real good idea. That goes much further than just looking at turnover assumptions and early retirement assumptions; it deals with the way in which the organization is going to proceed, going forward, in a wide range of areas. There is much useful information to be had.

I think the past is rarely a particularly good predictor of the future, but in our profession we tend to drive our cars by looking in the rear view mirror. It's hard to change that history, but my hope is that we're starting to do so.

MS. RAPPAPORT: I'd like to make a comment about turnover rates. One of the things that some of the human resources practitioners are recommending is a kind of targeted turnover that takes, say, 5% of the workforce each year, the poorest 5% performance wise, and moves them into different jobs and terminates them. Some human resources professionals are advocating this as a way to help manage the workforce and improve performance. The minute you do something like this, turnover is of course going to change. Turnover is also very labor-market driven, and we've had a slow job market in many areas in the last few years. But I think that's reversing itself in many areas as well. So it's not just the downsizing; certainly companies that undergo radical culture change with very different new compensation structures are likely to see different turnover.

One of the other things that I heard one of the speakers contend at this week's National Health Insurance (NHI) meeting was that nobody has designed compensation structures that, from his perspective (and this was a professor who had done a great deal of research), met some of the new cultures. So something to watch is how compensation structures are being changed and the way people are moved in and out of jobs.

MR. ZEISLER: At this point, Steve is going to present a few case studies to give you a sense of how programs work and what some companies have done recently.

MR. WHITE: There are four types of case studies: organizations with a change in job requirements or skill sets; a change in ownership or new culture; a continuation of prior culture; and closing a department I am going to concentrate most of my talk on the first one because I had a chance to talk with a company that just went through one of these; the company was looking for a new skill set.

Being from Seattle, I was able to talk with representatives at an unnamed northwest aerospace company. It had approximately 110,000 employees. They had a goal to reduce 11,000 jobs—a big reduction in force for this company. They had no history of early retirement windows or severance payments, although they do have quite a history of layoffs. They haven't had many large layoffs lately, but over the last 20 or 30 years, there have been a number of times that they have laid off a great number of people. Those layoffs typically focused on blue-collar jobs and not so often focused on the engineering or the high-paid jobs. In the current situation, they were looking more to eliminate many of these positions.

This year they did decide to go with an early retirement window for two reasons. One, to reduce the number of involuntary layoffs in a bid to help employee morale. But the bigger reason was to work toward a goal of a new skill set. So they took a good look at whether or not a window made sense for their situation. A big reason they thought it did was because they were looking for a new type of expertise, particularly in their engineering workforce. Retraining was an option, but they thought it would be helpful to have a window. Some of the older people might not have had the skills that they were looking for, if they were going to continue to be competitive, especially considering the way they were going to build airplanes over the next 10–20 years.

They also looked at this as an opportunity with two advantages. One, you have the employees who are going out who are going to be happy. Two, you have the employees who remain and have more opportunity to move up in the ranks or gain more responsibility.

The specifics of the window they offered were announced in March. They made it retroactive to anyone who retired after January 1. This was an attempt to eliminate some of the resentment of people that just missed out on the window. The window period was through mid-June, so it was recently completed. Employees had the option to cancel their window acceptance at any time up to June 30. The company has a fairly good defined-benefit plan and added a five-plus-three window. They decided to go with the five years of service as the main kicker. They already had quite low early retirement reductions (I believe it's unreduced at age 60 and is 88% at age 55), but they did add three years to that provision. So the group targeted was those age 55 with ten years of service. This group comprised 14,000 active employees (not many companies are as big as the group that was offered this window).

They had a retiree medical plan eligible to people at age 55, so that worked well with what they were trying to do. They also had a 401(k) plan and a history of a defined-contribution plan prior to the 401(k), so many of these people also had a large balance in their 401(k) defined-contribution plan. Many of these people had long periods of service, and they were going to be able to afford to retire. They did make the decision to offer this to all but the executive group. Although there were some people they probably didn't want to offer it to, they offered it across the board to prevent any employee bad feelings.

I determined from my discussions with the representative that they did a good job. They hit hard on the communication issue to make this work. They presented benefit statements to all eligible people, showing the difference before and after the window. They had numerous follow-up discussions in newsletters and targeted mailings to the eligible group. They offered counseling sessions both in groups and had one-on-one sessions. They were clear in their communications that this was a one-time event. They had no history of windows, as I said earlier, and they wanted to make it clear that this was never going to happen again. Obviously you can't say never, but they wanted those who did not elect the window to realize that this was not going to be coming up again. And they were also clear that the retirement was voluntary. They made a big effort to instruct all the people in the human resources group who were going to be communicating the window that this was a voluntary window and that they should not communicate it otherwise. So they wanted to make it clear that there was no hidden agenda.

The window period is over now. The retirements start July 1. So if you're looking for a new business to start, you might try something that attracts new retirees in Seattle because we have 9,000 new retirees starting July 1. That is a very high acceptance rate in my opinion, 64% (they were somewhat overwhelmed at how high it was). Acceptance was pretty uniform across groups; it wasn't specific by pay rate or location and there were no real distinguishing characteristics. It was a high rate any way you cut it. The company was pleased with the results. Their goal was about 50% acceptance. As I said at the beginning, they were looking at eliminating 11,000 jobs. They had already laid off a couple thousand, and their goal was to get maybe 7,000 in the window and then lay off another 2,000. Well, they recently announced that there would probably be very few additional layoffs because of the success of the window. There will be some expense in the window, but also some good feeling among the employees that the layoffs are pretty much over.

There is concern that they're going to be missing some expertise, but I guess it's not a great concern. With such a huge workforce, there is an ability to move people around and find the expertise among those remaining. There may be some smaller groups or small departments that are going to be hurt, but they're not looking at that as a major concern.

I'll briefly discuss the costs; the preliminary estimate was that this would have a *FAS 88* cost of roughly $400 million, and that was assuming a 50% acceptance rate, but I don't believe they have announced the final cost. It's probably going to be more like $550 million, I would expect. The plan is not fully funded, so they're not going to get out of this without some immediate cash cost. Obviously they have a curtailment in retiree medical and that's also going to have a big cost. They are fortunate enough to have some unrecognized gains on the retirement medical plan, so they're not going to have to take the retiree medical hit immediately.

Just to review, they're happy with the results of the window. They attribute its success to the planning that went into it. They gave much thought as to whether this would make sense to the workforce. They put a great deal of thought into how they wanted to design it. Most importantly, they communicated it hard and tried to make it clear and in the open to the targeted group as to what they were trying to do with this window.

There are a few other case studies or ideas that I've come across. We work with some multiemployer plans. Many of the industries where multiemployer plans are big are having to reduce workforces. We have some plans in the northwest wood products area, which as you know is being hit with less work. Those who are currently employed have plant shutdowns as well as less work.

What can be done to accommodate these realities and make it easier for employees? A typical arrangement is to offer unreduced early retirement, such as a "30-and-out" plan. This is not a window, but a change to the plan itself. It might be for all employees, across the board, or anybody who is eligible. The idea is to provide a mechanism for some of the older people to retire gracefully and to avoid having to eliminate other jobs. This approach can be used in the case of a plant shutdown; "30-and-out" benefits can be made available to that group.

There's another idea that we've used that has been fairly successful. One of the problems with multiemployer plans is the maximum deductible problem: if the plan becomes fully funded or close to it, the contributions are not always going to be deductible. The typical answer is to improve the plan so that the contributions will be deductible. This can be a concern if you have a downsizing active workforce with less contributions coming in, so you want to protect the plans funded situation.

One option is to use a spillover defined-contribution plan and have a defined-benefit and defined-contribution arrangement. If the contributions are deductible, you put them into the defined-benefit plan; if they're not deductible or if they're above what would be a targeted contribution rate to the defined-benefit plan, then they go into the defined-contribution plan. In this case, the employees become much more focused on the funding status of the plan. They're hoping, obviously, to get the defined contribution as well as their ongoing defined-benefit plan accrual.

One other case study just for fun. This is a professional baseball organization. It is the Los Angeles Dodgers. I guess we won't speculate as to why they're downsizing—maybe all baseball organizations are downsizing these days. But this one has a fairly creative option for a gradual retirement. Gradual retirement, if we look ahead 20 years or less, may become a common option. This organization has a retirement by increments (RBI) plan for employees over 60, which they call the RBI plan.

This plan basically lets the employees phase out of their active work life and phase into retirement. It is mainly geared toward the regular compensation. You can go out over three years, for example, with a proportionate reduction of your pay. The first year you would get-two thirds of your pay, the second year one-third, and the third year you would be fully retired. To help accommodate that, they have a provision in their defined-contribution plan for in-service withdrawals so that only those people who are in the RBI program can withdraw money from the plan to make up the phased reduction in their pay.