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The Changing Look of Retirement Plans

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Summary: Panelists discuss current trends in the design of retirement programs. They cover the structure of these programs and the impact on benefit levels for various employee groups. Additional information on retirement plan topics is covered in detail in subsequent sessions.

Participants are introduced to a variety of topics in retirement plan design and are encouraged to pose questions to the panel following their presentations.

Mr. William Torrie: I'm a principal with PricewaterhouseCoopers, and I have been doing pension work for about 20 years or so. Dave Yackel, a partner with Chernoff Diamond, has 20 years of experience, too. Dave's most recent current experience is in the small plan area. Bob Barry, director of retirement practice for Watson Wyatt Worldwide in Boston has 30 years of experience, mostly in large plans.

Mr. David A. Yackel: When I first started in this business in the late 1970s, we didn't have TEFRA, DEFRA, Retirement Equity Act, or the Tax Reform Act (TRA). The only thing we had to worry about was ERISA. At that time defined benefit (DB) plans were holding their own. In the 1970s, the success story of the 401(k) led to the greater success story of 401(k) in the 1980s and 1990s.

Before TRA, we had plans like individual DB plans for law firms, where each partner in a law firm had his or her own individual DB plan. We called them IDBs,

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Note: The charts referred to in the text can be found at the end of the manuscript.

and they passed under an old comparability rule. All you had to do was have a profit-sharing money purchase plan for your staff, use the old comparability rules, and everything was hunky-dory. Then TRA came along, and all that is gone.

In the pre-TRA days, for the smaller employers, you could use all the past service that these employers had built up when they never even had a DB plan because they couldn't afford it; they were just building their businesses. Generally, these people were older than their staff members, so the DB plan worked very well; it skewed most of the contributions right to the owners, and everybody was happy, at least in small plan environments.

Lo and behold, we're at TRA. Most of the DB plans are terminated. Luckily for us they put in something called the general test and we could have cross-testing. In cross-testing, we take the defined contribution (DC) allocation and convert it to a DB type of accrual. We can weight contributions to the older employees, who are typically the owners. This is very important in the small plan environment. Before TEFRA we had the top-heavy rules. That's another reason why most of these plans were terminated.

I want to get into where we are now. The buzzwords we're looking for to describe why 401(k) plans became popular are "portability" and "cost sharing." Employees could share in providing their benefits. Now the new buzzword is simplicity. Recently, they put in the Savings Incentive Match Plan for Employees (SIMPLE) 401(k) plans and the SIMPLE IRA. With the SIMPLE IRA eligibility, you have to have 100 or fewer employees. You have to cover all employees who earn \$5,000 or more during the year or the two preceding years. Under the SIMPLE 401(k) you can defer \$6,000 a year. The employee doesn't have to do the average deferred percentage (ADP) test if the employer contributes a 2% non-elected contribution or matches 100% of the first 3%.

The plans come in two flavors. In the SIMPLE IRA, you can contribute less than 3% for any two of five years. If you're doing the 2% non-elective contribution, that counts as a 3% match year. In all these cases, the employee contribution is 100% vested.

Here's another little wrinkle. Under the SIMPLE IRA, you don't have the \$150,000 compensation limit for a match. It still applies if you're doing the nonelective contribution. That means if someone has a 3% match on the first \$100,000, he or she can get to \$6,000 and use compensation up to \$200,000 to get it.

The SIMPLE 401(k) is about the same as the simple IRA except you can only maintain another qualified plan for the non-eligible simple 401(k) participants.

You're still covered by the 410(b) rules. For the non-elective contributions, you have to contribute for anyone who has \$5,000 in compensation, and the \$150,000 compensation limit applies to the match. Again, it's 100% vesting.

What are the advantages of these plans? There's no discrimination testing and no top-heavy requirements. For the SIMPLE IRA, you're not capped at \$150,000 for the match. And, if you're allowing people to place their money into their own individual IRAs, you relinquish the fiduciary responsibilities.

One disadvantage is that you no longer have a \$10,000 index limit. You now have a \$6,000 index limit. Another is that, if you take any distributions in the first two years, you don't have a 10% early distribution tax, you have a 25% tax. With the safe harbor contributions, you don't have the flexibility to make contributions at the employer's discretion, so it's fairly limited.

Starting in 1999, a new concept, called the safe-harbor rules, are going to be important. These rules are not just for the small plan environment; everyone can use them. They have some nuances that are very important to my clients. If you use a safe harbor, you don't have any ADP test, but all the contributions have to be a 100% vested.

You have two ways of meeting the safe harbor. You can have (1) a qualified non-elective contribution (QNEC) of at least 3% of compensation or (2) a qualified matching contribution (QMAC) that is 100% vested, where you're matching 100% of the first 3% of compensation deferred plus 50% of the next 2%.

You can have some differences here. As long as your matching contributions never increase with increasing deferrals, you can have a little variance in this match, but the match at least has to be equal to the safe harbor match. So you can do something a little more in the beginning, as long as the answer comes out to roughly the equivalent result at the end. This gives you a little flexibility.

If you want to do away with the average contribution percentage (ACP) test, there are two more requirements. First, you can't match any compensation more than 6%. If you want to match in excess of 6%, you can't meet the safe harbor rules for the ACP test. Second, you have to be sure that the highly paid do not get a higher rate of match than do the non-highly paid.

What's good about this for my clients is that the QNECs and the QMACs can be used to satisfy the top-heavy rules. They can be used to do the ADP test and the ACP test, and can be used for cross-testing plans to meet the general test. So it has three purposes.

When I first started doing 401(k) plans, we started with annual valuations, and then we moved up to quarterly valuations. In those days, we had very limited investment choices. We started off with this pool of funds and the employer chose the investments. Then we gave employees one or two investment choices. Everybody was very excited about that.

There were a lot of insurance products then and very negligible investment advice. We weren't qualified to give investment advice. I don't know what kind of investment advice insurance companies were giving. It could have been good because they all were in these annuity plans.

In the late 1990s, even in the small-plan environment, we have daily valuations and comprehensive investment choices. I have a plan with less than 50 employees who have 20 investment choices. We have a voice-response system. Also, we've gotten into the habit of giving very general advice on investments: This is a stock, this is a bond, etc. On January 1, 1999, we're setting up our first Internet access for the plans. We also have individual brokerage accounts. In a lot of higher-paid cases, especially in the law firms, everyone wants to use his or her own broker. Now it will be possible to do so.

We give individual investment advice by taking people from the investment houses to client meetings. They look at everybody's investment on a computer and ask, "How much do you have to put in equity funds? How much do you have to put in bond funds?" It's a great thing.

One thing keeps those of us in the small plan environment in the game. With the demise of the DB plan, came the cross-tested profit-sharing plan—and new comparability. That's the look today. In the mom-and-pop shops, where the owner is typically older than the staff, the exercise is providing a \$30,000 contribution to the owner and 3% top-heavy minimum to the staff.

Professional firms such as law firms have been looking at different things. They allocate contributions to different groups. For example, we allocate enough to give the partners the 25%, up to the \$30,000 limit. The associates, historically, get nothing. For staff employees and paralegals, some plans are more generous, but the majority are trying to get as close to the 3% top-heavy minimum as possible.

In 1994, the IRS said, "You can't do that. You're not providing definitely determinable benefits." It then issued a field directive saying that the employer had too much discretion to choose how much went into each group, so it was not definitely determinable. Then the IRS realized that, "For years, we've been doing it

with a match and a non-elective.” When all of those plans started going out the window, the IRS realized it had opened Pandora’s Box.

In 1996, the IRS repealed that directive and said, “From now on, we’re going to consider these plans to be definitely determinable.” So this concept is still around and very popular in the plans that I administer.

More recently, for my clients, two things started the ball rolling. One was the repeal of the 15% excess distribution excise tax. Basically, before that, if you had too much money in DB and too much money in DC, and you wanted to take some out, the IRS would hit you with a tax. That was repealed and it’s a good thing.

Coming up in the year 2000, the combined limits on the 415(e) are supposedly going away. That’s another good thing. It opens up the door for DB plans, at least for my clients, and especially for the ones who are doing well. It allows them to have cash-balance plans, where they can exceed the \$30,000 limit that they now have in their DC plans.

In cases with an older owner, it’s a very large improvement. The other good thing about the cash-balance plan is that clients can understand it. You tell them they have the security of a DB plan, and it looks, smells, and feels like a DC plan.

Unfortunately, you still have a few things to worry about, such as the top-heavy rules. That’s not something the larger employees have to worry about, but for lawyers top-heavy is a big issue. I’m trying to provide a cash-balance type formula and have to contend with a top-heavy minimum benefit that’s based on final average pay. Most of the cash balance plans I put in are combined with a DC plan—usually, a cross-tested profit-sharing plan.

In that case, I try to provide the top-heavy minimum in the DC plan so that I don’t have any problem with the DB plan. The safe harbor is a 5% contribution. If you want to get very fancy, the rules show other ways in which you can meet the top-heavy minimums.

Under the cash-balance plan, we have employer credits and interest credits. Usually, employer credits are given either on a percentage of pay basis or an age-adjusted basis. In my case, if the owners are older, I want them to get a higher percentage of pay to support the plan. It’s like using a cross-testing approach but with a cash-balance plan.

The interest credits are usually tied to some index, such as one-year Treasuries. They are independent of the actual investment return on the assets, which is a

concept that's a little hard for the employers I deal with to understand. They still want to know why the contribution credit differs from what they have to put in. But they're getting used to the concept.

I've been told that a number of firms have a myriad of investment choices. both in equity funds and in index funds that are equity based. I've heard that one firm has 17 investment choices and each employee gets to choose his or her investment in a cash-balance plan. Of course, it's a pseudo account, and they're not really investing in those funds.

The investment risk is still with the employer, but employees' accounts are going to go up and down based on the choices they make, just as in a 401(k). Some plans give employees a safe harbor if the plans don't do well. They have a 5% interest rate floor, so they never have less than a 5% return on their money.

With cash-balance plans, like any DB plan that has a lump sum option, you have to contend with the 417(e) rules. It's especially interesting with the cash-balance plan because, in order to determine accrued benefit, you take the cash-balance account projected with an interest rate to retirement age and then convert it to an annuity.

If the interest rate you're using in your projection is more than the 30-year Treasury rates, you're going to have a situation where the cash-balance account you're starting with will mysteriously grow to a much larger amount due to something called a "whipsaw" effect. This is basically projecting at an interest rate that's, let's say, 8%, and discounting at a rate today that's about 5%.

The IRS came out with Notice 96-8, which says that, if you use 30-year Treasuries as your projection interest rate, you can always give out the account balance.

This has another very interesting effect. If you provide lump sums in the DB plan, the only plan where you are not subject to the 417(e) problem, you don't know what you're allowed to give out because the interest rates can change. In a cash-balance plan, using 30-year Treasuries as your interest rate for projection purposes, you can always give out the benefit you're funding for. That's another plus for the cash-balance plan.

One of the problems I find in trying to convince clients to go to any DB plan is the concept of overfunding and underfunding, especially underfunding. They are very concerned about what will happen if the investments don't do well and they have to pay off these unfunded liabilities. What happens if they're having a bad year or can't afford it? One of the methods I use to get around that is a floor-offset approach. Under the 401(a)(26) regulations, you have to have an offset that actually

accrues under the other plan. The benefits under the other plan are earned on a reasonable uniform basis, and the offset is not used to reduce benefits in the other plan.

How do I use that? I take a DB plan and provide a high benefit for people I want to benefit, such as the owners or the partners of the firm, and a low level of pay credits under the cash-balance plan to the staff. Then I offset it with a money-purchase plan. Usually the money-purchase plan is getting a contribution at exactly near the pay credits under the cash-balance plan, so I'm left with only the higher-paid owners who are actually receiving a defined benefit under the cash-balance plan. They can live with that. If the liability that they're going to be held accountable for is just for the owners, they're very happy. And, if it's only for majority owners, they always have the wherewithal to waive their benefits.

Partners in a law firm are also more willing to take on that liability if they know it's just for themselves and they won't have to worry about their staff.

Recently, the American Association of Pension Actuaries (AAPA) presented a new plan called Secure Assets for Employees (SAFE). The buzzword used to be "simplicity"; now it's "security." Under the SAFE plan, we have the marriage of the career average pay plan and the cash-balance plan. Again, as in all of these simplified plans, you always have a 100% immediate vesting.

In a SAFE plan, the normal retirement age is 65 and the Social Security retirement age. There's no choice. If you have two years of service and earn in excess of \$5,000, you're eligible.

The actual contribution that goes into the cash-balance type plan comes from using a career average pay formula. You could either have 1%, 2%, or 3% of pay going into a career average pay plan each year. You get to make an election with no amendment required. Then you determine, under a real unit credit method using 5% interest and a GATT post-retirement mortality, the exact contribution that would be needed to fund that career average pay benefit. That's what goes into the cash-balance plan and that's the initial contribution that goes into the account.

The account is invested. If the cumulative contributions that go in earn less than 5%, the employer makes up the difference. If they earn more than 5%, the employee gets to keep it. So it's basically a guarantee of 5%, and that's why it's secure.

The SAFE plan also has another concept called past service credits. Basically, you can have up to ten years of past service credits. For any year prior to the inception

of the plan that you have a past service credit, you can double your accrual rate. So, if you elected to give everyone 1% for the current year, you can have a 2% past service credit. If you make no accruals in that year, you will lose that year's past service credit as well. You get the first ten years of the plan to use it.

It will give you up to ten years of past service. If you started in the plan in January 1, 1999, and were first were employed in January 1, 1989, you can get ten years of past service credit. Therefore, over the next ten years of the plan, whatever the accrual rate that the employer elects, 1% or 2%, you could get double that past service credit. The contribution that's going into your account for that year is what would govern the past service credit.

From the Floor: Does it gets paid year by year though?

Mr. Yackel: Yes.

From the Floor: At the rate for that year?

Mr. Yackel: Yes. And then you lose it. It's just available that year. If the employer decides to put nothing into the current year, and there's no accrual for that year, then you will just lose that year's past service credit.

From the Floor: It's real unit credit funding then?

Mr. Yackel: Complete unit credit. The only difference is, if the 5% cumulative return is not earned, you have to put in the difference. You also have the opportunity to buy an annuity with it. So the employer could have no underfunding. If employers choose to change one from an account balance to buying an annuity, and you don't have enough money, they have to make it up immediately to fund that annuity.

From this concept came a new one called Secure Money Annuity or Retirement Trust (SMART), which is for companies with fewer than 100 employees, which I like very much. In this case, you can't maintain another qualified plan other than a 401(k) plan that provides the safe harbor matching. If you have the safe harbor 401(k) plan, you can have one of these SMART plans, but you can't have any other plans that you contribute to.

The exception is when the other plan is a collectively bargained plan. If none of the collectively bargained employees will be eligible for the SMART plan, you're still okay. Again, it's 100% immediate vesting, with all the benefits in the form of a life annuity payable at age 65.

In this case, you can't use the \$150,000 limitation. The SMART plan limits you to \$100,000. It's a career average pay concept, but, there are no past service credits. It's 1–2% of compensation for the year. For the first five years, you get 3%. The employers elect a percentage before the beginning of the year and notify the participants.

The Clinton administration would not make this plan available to any professional service employers. He's mad at the lawyers right now, so he doesn't want them to have anything. This would allow you to get by with lower PBGC premiums. If you're never going to have an unfunded plan in the first place, why you would need PBGC premiums, I haven't the slightest idea. But at least they're going to make them low. Under this plan, we're looking at 5% interest and GATT post-retirement mortality serving the contribution.

Interestingly, in the distribution area they're not going to allow you to take any money out of the plan prior to age 65 except for death or disability. The exception is if the distribution is on account of a separation from service and is less than \$5,000. After separation of service they are transferred into a SMART annuity, where new individual retirement accounts subject to the SMART distribution rules are allowed. The SMART plans will be exempt from nondiscrimination rules, top-heavy rules, IRS 415 limits, and, I guess, if they're "smart" enough, even from the actuaries.

Congress has said, "We're looking at putting all these neat things together to get the smaller employer to put on a pension plan." Well, there's one problem: Both plans are too expensive, so, the government is going to subsidize their startup. This is very good. Unfortunately, it will only subsidize employers who have 100 or more employees.

One exception is having a qualified plan that accrued benefits and allocations. This is HR3672. We're past that, and it has a million other exceptions, but I'll use this one as an example of what the government is looking at.

In HR3672, they were going to use a window theory, opening in 1997 and closing on January 1, 2001. During this time, you could establish the plan and the government would subsidize 50% of the qualified startup costs up to \$1,000, and up to \$500 for the second and third year, and zero thereafter.

Recently, Senator Bob Graham (D-FL) introduced S2130. It raised the \$1,000 and \$500 to \$2,000 and \$1,000. Then on October 5, 1998 the ERISA advisory council

agreed to recommend a \$2,500 credit to the labor secretary. Basically, all of the subsidies come in a form of a tax credit.

So, the way I see things in the future, we're talking about simple plans, secure plans, and maybe the government paying my bill.

Mr. Robert Barry: I would like to comment on the changing look of retirement plans. Dave and I operate in very different worlds, so we separated our presentation into smaller plans and large plans. I will take a treetop look at where retirement plans are headed. I will get into the aging work force; some of the trends in DB, DC, and hybrid plans; and pension simplification legislation. Although after Dave just went through simple SMART and SAVE, I'm not sure we're simplifying anything. Finally, I'll talk about Web-based retirement communication and the global implications of the retirement business.

Let's start with the aging work force. The world around us is changing rapidly, and most of us in the front end of the baby boom generation, which is a large part of our population, are coming through the last part of our working career now. That's changing the way employers are looking at their work force, how they manage their work force, and what they want to provide in terms of retirement/savings programs, both to incentivize those people to work more and to provide adequate retirement income for them.

Here are a couple of statistics. The percentage of the work force over age 45 is expected to increase from 30% today to 40% by the year 2010. That's not very far away. This significant a change in the population covered by retirement programs has some cost and other implications.

The percentage of the population over age 65 is expected to increase to 20% at the same time that the availability of younger workers is shrinking. There's a glut of workers 20, 25, and 28 years behind the baby boomers, but a shortage of people 10–15 years behind. Employers are becoming aware of that and trying to figure out how to respond.

As an aside, some statistics from a survey that we conducted show that the percentage of the population in the entire U.S. by the year 2010 is going to mirror the percentage of the aged population in Florida today. So, within the next 12 years, the entire U.S. is going to have the proportion of people over age 50 that Florida has today. That's sobering when you think about it.

When you start to look at averages and age range, some anomalies show up. Chart 1 shows the large percentage growth in the 40–49 age range that's taking place

during the 10-year period from 1991–2001. And that whole group is moving forward in the next 10 years.

For the large employer plans that we work on, this means an increased need to attract and retain some of the shorter-supply workers right behind the boomers. There's some question about the adequacy of 401(k) plans and the general perception of Social Security being at risk.

It also means that these employers are experiencing growing costs in these retirement plans, true accrual costs, if you will. As baby boomers age and become a larger and larger portion of the work force, the cost of providing a unit of benefit for them is going up. And it grows pretty rapidly in the last 10 or 15 years of work.

Trends in DB and DC

DC assets for the first time exceed DB assets in the U.S. That's amazing when you think about it. Ten years ago, it wasn't even close. That says there's a large movement out of DB and into DC plans, which doesn't surprise many of us. A lot of that has taken place in the smaller plan area, but it's also happening more and more in the large companies.

Hybrid plans represent a middle step, but a lot of larger companies are giving up the ghost and going DC. If it weren't for the issues surrounding current overfunding and access to the assets in these plans, I think you'd see a lot more of this.

The number of DB plans has decreased from 149,000 to 66,000 plans from 1985 to 1993, and it's dropped even further since then. We don't have a good statistic from the Academy, but I have heard that it's down 50,000 or less now. That's a big change in the way we deliver benefits to the U.S. work force.

So what are these higher costs, the aging of the U.S. work force, and the proliferation of continued regulation on DB plans causing employers to do? For one thing, nontraditional plans, hybrid plans are becoming significantly more prevalent. As David said, cash-balance plans are communicated to the uninitiated work force as DC plans. Even though we in this room might recognize that technically they are DB plans, most of the population assumes that these notional accounts are real accounts.

It doesn't matter how well you communicate how they operate, people understand that they have these accounts in these plans, so they think they're DC plans. There's a good reason for making them look that way. It's the perception of value that people have, correct or incorrect, and I'll talk about that in a minute.

There are also Pension Equity Plans (PEP) and cash-balance plans. All of these are just different methods of providing a DC look-alike in a DB technical environment.

A cash-balance plan is simply a notional account where the employer is putting in a certain contribution that varies by age, service, or both, and it grows with some declared interest credit.

This is opposed to a PEP plan, where the amount in the account is a much larger percentage of final average earnings. In a given year, 10–15% of final earnings might be contributed to a notional account. It doesn't necessarily grow with any interest at all.

These plans deliver benefits in different ways, but, in essence, they're both DC look-alikes that are technically DB plans.

Every time someone comes up with a new rule or law, a bunch of creative people—actuaries, lawyers, etc.—try to figure out 735 ways around that law to slant benefits the way they want, to the people they want, and still be technically within the guidelines. This is, to some extent, a response to the changing work force and the perception that the younger people coming up behind have of DB plans.

Some employee choice plans are emerging. For example, the new NationsBank cash-balance plans not only look like DC plans, but also give employees investment choices. They're giving significant investment choice to the employees with some sort of underlying guarantee in order to have it still qualify as DB plan. That guarantee, in many cases, is almost misleading because it's so small.

I think that companies are starting to push for that more and more to see how little they can guarantee and still have it qualify. So what we're going to have is individual notional accounts that the employer is investing with the direction of the employee, with no guarantee underlying it, or no meaningful one anyway.

Initially, they were requiring a 5% guarantee. The lay person would say, "The minimum we're going to earn in a year is 5%." But those of us who are clever say, "No, it's 5% cumulative." So if we have a year that we have credited 10%, we're going to set that excess aside and use it to fund the years when it didn't earn enough. So we constantly are coming up with ways around these rules.

We surveyed a large number of workers, and found an interesting, but not surprising, phenomenon: that younger people tend to favor DC plans and older people tend to favor DB plans—even when they're of the same value. The question wasn't "Would you rather have 5% of pay versus some lousy DB plan." The plans

were of equivalent value. This shows that people are a little smarter than we think because the accrual patterns in the later working years, in fact, result in higher contributions than in those early years.

Some trends are driving the use of DB and DC plans. The first is cost. The aging work force is driving costs up. In an environment where all of the medium-size and larger companies are competing to become more productive and to reduce costs, benefit costs are continuing to go up. The other two trends are perceived value and retiree medical, but let's look at costs first.

Chart 2 shows the costs to employers in a common DC and DB plan. We took a 4%-of-pay DC plan that stays flat throughout that whole age range and calculated an equivalent DB plan. The latter starts at 2.5% and grows to almost 9% of pay. That's the difference in costs that these employers are facing.

We started with the aging workforce, which is now going to be 40% of the population at the tail end of that chart. As we baby boomers move through, we're causing costs in these plans to skyrocket. So one of the reasons employers are shifting to DC plans, in addition to legislative environment, etc., is the costs that they're experiencing.

The perceived value graph (Chart 3) is complicated and requires quite a bit of explanation. Our clients are trying to get the biggest bang for the buck they put in. They have designed their programs with a different primary focus from what Dave is dealing with, where bang for the buck is defined as how much do I get.

My clients are looking for a return on investment through retention, the ability to attract better people, increased productivity, you name it. And I'm going to have a challenge for us as actuaries when we finish.

The graph shows that return on investment on the vertical axis and the amount spent on benefits on the horizontal axis. If we were in a perfect world, we would get a dollar return for every dollar spent. But the reality is that if we have lousy plans, it doesn't work that way. For example, I'm embarrassed to say I was the actuary for a steel company not too long ago that had a plan that paid \$2.75 for each year of service. That's an actual benefit. So with 40 years of service, you would get a \$110 a month. That plan is at the low end of the value spectrum and the amount being invested.

If you had a plan like that, I think you'd be getting negative value from it because the people would stand around the water cooler complaining about how rotten it is.

So, when you start spending dollars on these plans, if it's not designed at some minimal sufficiency level, you're going to get a negative return for that investment.

As you continue to spend dollars on the plan, you will start to turn that around, and people will perceive that they have some value. And, at some point, it is going to become rich enough that you're going to face diminishing returns. That's when it starts to tail back toward an actual value. The bottom line of the graph indicates the middle-aged or older worker, and the top one represents the younger worker. And probably they're farther apart than that in most situations.

This depicts that every employee has a different perceived value versus actual value measure. And, as we change through our working career, our perceived value changes also. As the survey revealed, regardless of the amount spent, and even though the values were identical, the perception was that the DB plan becomes worth more than the DC plan as people age.

A large employer is trying to design a plan that will to meet the needs of every worker, so we're looking for the greatest distance between the curve and the straight line. When the curve is above the straight line, employers are getting more for their investment than they're putting in.

Here's a simple example. If you went to an employer who had a traditional DB plan—let's say 1.5% of final three-year pay—and put in an equivalent cost DC plan, which had 6% of pay going in plus some match on the 401(k) to replace it, and then asked everyone under age 40 how they liked the new plan, they would all say they absolutely loved it, even if the employer was spending the same amount.

The reason is that they can see that the DC plan is theirs. They own it and understand it, which adds to their perceived value.

That means that, for the same amount of dollars, I'm getting greater return from those employees, I'm able to attract better employees, or I'm able to retain good employees because of their perceived value versus actual value. This is something I think we need to work on in the next generation, probably after my days of doing this stuff. But we need to focus on how employees value these things.

The trend is toward DC and self-selection, or employee self-service, if you will, in the pension world. That's where all of these things are moving. Employees will be able to take the dollars and self-select how they want to spend them.

Retiree medical is the third driver. Although it's not part of pensions per se, this is causing a shift in how dollars are being spent. Chart 4 shows that the percentage of

employers offering benefits to over age 65 Medicare eligible people declined between 1991 and 1996, requiring premiums to increase. And employers with caps went from virtually none to a fair number. This trend is just a cost shift from the employer to the retiree, and that's happening at the same time as these other shifts away from DB to DC plans, which tends to disadvantage the older worker.

The next driver is pension simplification and other legislation. Congress is recognizing the need to shore up private pensions. Unfortunately, right now, they're focusing on the small employer. I don't think they have become fully aware of the need for the larger and mid-sized employer, because they've done significant reductions there on a net basis. But our people in Washington are telling us that legislators are starting to realize how complex this is.

Congress actually had no earthly idea how complex the rules are surrounding pension plans. Since it found out, it's been looking at making some significant changes in easing the burden of the plan's sponsor and providing some tax incentives, Although, unfortunately, not to any of my clients.

With pension simplification, legislators are trying to eliminate a lot of the burden that prevents people from having DB plans. They're repealing the age 70½ rule and getting rid of 415(e) next year. In the pipeline is a reinstatement of the \$235,000 pay limit, and talk of perhaps going above that. That's a big change. We went from a pay limit of \$235,000 to \$150,000, and now they plan to jump back. That's a big shift in where dollars are coming from.

We expect legislators to eliminate the current liability for the full-funding limit, which has been an impediment to contributions. Legislation is focused on a social desire to have plans proliferate and add benefit. By the same token, Congress needs to do something on the tax incentive side if it's going to accomplish that goal.

I talked briefly about Web-based retirement communication. It wasn't too long ago that I was talking to some of my clients about doing special statements for people and providing them with benefit statements to help them understand what they had. And they said, "No, we can't get into that. It's too complicated. They don't understand it. Just put down the accrued benefit and the projected, and that's it."

Now employers are much more inclined to give their employees access to all of their own information. It's something called self-service. Employees can go out to a Web site and access their 401(k) balances, and in their DB plan, find out their accrued and projected benefit. They can model various assumptions about future pay growth and investment return. Then they can compare that with the retirement

need that they've defined for themselves and the amount that they're going to need to spend to maintain that standard of living in retirement.

This is growing very rapidly and moving pretty fast. Similar to a lot of technologies, the cost of doing it is coming down rapidly as well, so more and more people are getting access to this information. This, in essence, is going to be one of the things that will help bring back DB plans.

Over time, DB is still the least expensive way of providing a given benefit in retirement. I think the large- and medium-sized employers will understand that and cycle back because it's the most efficient way of delivering these dollars. A lot of things are in the way right now, though, including this need to replace the baby boomers as they go out.

Some new pension systems make administration much more efficient for the employer. This doesn't have to mean complete outsourcing, where there are benefit service reps or customer service reps answering questions, but just systems to allow for benefit calculation, communication, and forms, which will make it easier for the plan's sponsor.

Surprisingly, in a fairly quick move, some legislation has been proposed to allow all ERISA notices to be posted via the Internet instead of requiring all the paper that we have in the past. This is another driver here in the U.S. that is pushing the DB change, perhaps, the other way.

More and more companies are becoming global, however. A survey by William Mercer and Co. showed that 75% of multinationals saw retirement plans as one of the medium or top priorities. They gave different reasons: consolidation, efficiency, etc. But 75% ranked this as a fairly high priority. There's increasing centralization by these multinationals over the plan types and benefits. They're not necessarily all dictating what it's going to be, but they're trying to get similarity around the world.

I'll close with an interesting statistic. There are currently \$600 billion in non-U.S. DC plan assets, and it's expected to grow to \$1.3 trillion over the next five years. That's not from investment performance but just because these things are growing rapidly. So it doesn't look like the influence of global companies or multinationals is going to reverse the DB to DC trend at all in the near term.

From the Floor: You mentioned the NationsBank cash-balance design. My understanding is that about 20 years ago, insurance companies used to invest qualified plan assets in a very similar way, where people could elect to tie the ups

or downs of the investments with equities or bonds. Isn't that very similar to what's being done now?

Mr. Barry: In a lot of ways what's happening is very similar to the variable annuity marketplace. Insurance companies, 20-plus years ago, started selling variable annuities in response to the need to credit more than the general account was earning. So in selling a piece of an annuity each year, they were selling, in essence, investment choice to people, because the amount of variability of that annuity was going to be tied to some external index. So, yes, it's very similar.

From the Floor: And my understanding is there was often no underlying guarantees in that product either.

Mr. Barry: In most products, there was no underlying guarantee. They qualified as DB plans because they were purchased as an annuity. So the employer had purchased a DB annuity, and the risk was being undertaken by no one other than the participant.

From the Floor: My further understanding is that they went out of vogue when the market did some negative things.

Mr. Barry: It has a tendency to do that.

From the Floor: Do you have any comment about the future for these interesting investment-type cash-balance plans?

Mr. Barry: Yes. I have no clue about what's going to happen to equities in the next six months, and I'm not sure that I have any idea what the future holds. I'm sorry.

From the Floor: My first question is on the individual account management of the cash-balance plan. It's not clear to me, even though Mr. Barry commented a bit on ways in which this could be dealt with, how an employer can allow the individual employee to select, perhaps, the riskiest kinds of investments, and, at the same time, be at risk for guaranteeing some measure of that fund.

The second thing, and perhaps this is for both Mr. Yackel and Mr. Barry. Do you have any comments on how immigration policy might help to deal with the shortage of younger workers in the next 10–15 years?

Mr. Barry: Employers who are allowing individual choice or considering allowing individual choice are putting in modest guarantees. The riskier the investment choice they allow, the more modest they want their guarantees to be. That's where

this cumulative return concept of guarantee is coming from. But I don't think you're going to see a lot of companies going for that. There's pressure to do it, but I don't think it's going to happen for most large companies.

Immigration is an interesting issue. We've been debating that. There's so much politics involved that even if we could convince the world that we needed these workers, we probably couldn't bring ourselves to open up the borders enough to accomplish it. Most of us that have talked about this don't think we could do it politically. It's a potential fix, but I don't think it's going to happen.

Mr. Thomas Naffe Rice: What do you think the DB versus DC trend would be if we had several years of bad stock performance and hit the valleys in terms of investment?

Mr. Yackel: I personally think the trend is going to turn. At least in the legislation I've seen, when they're talking about security, they mean having the underlying 5% investment return in the plans.

So the next thing I see is having 401(k) plans. The only difference is that the employer gives some defined underlying interest rate, cumulative or whatever, so that the employee does not lose his principal.

I think NationsBank's guarantee is so small, that all it protects is the principal. It's guaranteeing a zero percent investment return on the contributions actually going in, but insuring the principal. So if you have employees who are just getting into the market and they're worried about losing their principal, at least the employer is covering that.

Whether or not they're actually going to invest, or allow these plans to invest the same way that the employees are, I don't know. I would presume that the employers would invest the money themselves, and just give the employees the option of choosing their investment return.

Mr. Barry: The movement away from DB plans has been much more drastic in the small plan area than it has been in the large plan area. There are still, however, a lot of large employers who would want to go to DC plans and haven't because they have significant amounts of excess assets in the DB plan. So they've gone to a cash-balance plan as an interim strategy to help use up those excess assets.

If the market did that for them and we had sustained poor performance for two, three, or four years, I'm afraid that a number of them would jump to DC at that point in time. But I still don't think it's going to be significant. Hopefully, the plan

sponsors are smart enough not to jump into the wrong design just at the time when they should be taking advantage of the potential investment gain. And, after three years or four years of sustained poor performance is the wrong time for them to jump, but I think that some would.

Mr. Torrie: I've been involved with cash-balance plans for a while and it concerned me that we were creating plans and valuing them as pension actuaries would. Perhaps we're not using the appropriate actuarial techniques. These cash-balance plans, in many cases, are essentially deferred annuity contracts. You put in a certain amount of principal, it grows, and, at the end, you are allowing people to convert these accounts to annuities. If you look it from a very broad perspective, that's what it looks like.

Then you start throwing in guarantees. A lot of these guarantees are put in because the employer sponsor thinks it would be nice. Sometimes you end up putting guarantees in the plan that maybe don't belong in there. If you were an insurer, you would have to talk to your actuary and find out what the real cost is, and maybe it's not quite what the actuary thinks.

I have a story. Early on, we were putting in a cash-balance plan and it got to the board of directors. We had a very simple plan. The interest credit rate was one year T-bills determined at the beginning of each year. Since this was in the mid-1980s, soaring interest rates were still in the memory of some of the directors, so somebody said, "Let's put a 12% cap on that." At this point, the vice president of human resources became a bit insulted that somebody had changed his plan specs. So he said, "Sure, but we'll have a minimum interest guarantee of 5%." I was probably still a fairly naive actuary, and along with most of the people in the room, just let it go.

But as interest rates have fallen, we're seeing a long period of time where 5% seems large. Then you get into the question, "Is this 5% interest guarantee part of the accrued benefit?" I've found at least two different people with two different opinions. But, we'll see what happens.

As a result of this, I made a proposal to a committee of the SOA that we ask for some competent person to let us pension actuaries know if we should be looking at techniques for valuing cash-balance plans. First of all, we should identify these unusual characteristics that are falling into cash-balance plans and then find out if we should be making the actuarial profession aware of it.

This goes well beyond minimum funding requirements. You might still have the same old minimum funding requirements because you use the same old methods

for that. But I think it would help pension actuaries who are designing these plans and maybe valuing them to let the plan sponsors know about the risks they are actually taking on. As Bob mentioned, they are somewhat aware of this. They may not do anything too outlandish, but sometimes you might make a subtle change that catches you by surprise later on.

From the Floor: I'm new to the cash-balance plans. Do you think that it's going to be a requirement to put in a minimum floor of zero percent for cash-balance plans in order to avoid anticutback rules and so forth in the accrued benefits?

Mr. Barry: Yes. I think ultimately if we continue to push the envelope, somebody is going to step in and put in some minimums that make sense. And I mean real minimums with teeth in them, because, if we continue to make these things DB plans with choice, that's not going to match the intent of what the IRS is allowing.

We were just talking about the assumptions on cash-balance plans. I think we may want to think about whether or not to build in volatility for the investment return. In other words, we can assume that the employers are earning 8% on their invested assets. But if there is an underlying guarantee, and it's an annual guarantee as opposed to a cumulative one, we should probably be building in some volatility assumption so that the guarantee operates sometimes.

Mr. Torrie: As employees change their investment elections does that mean, from the company's perspective, that they should be readjusting the asset allocation? How often should one do that and monitor it? It sounds like you'll need a lot of actuaries.

CHART 1
AGING WORKFORCE

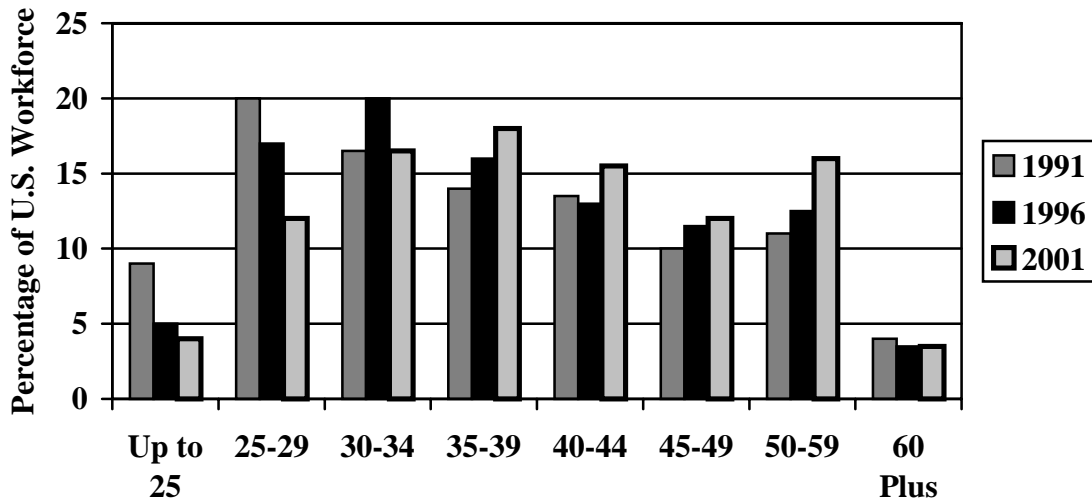


CHART 2
TRENDS IN DB AND DC—COST

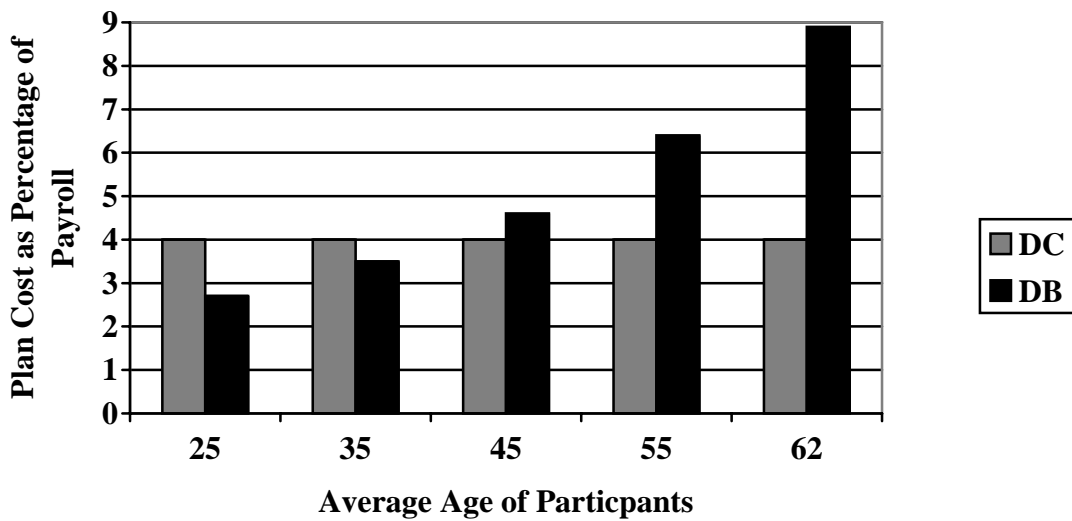


CHART 3
TRENDS IN DB AND DC—PERCEIVED VALUE

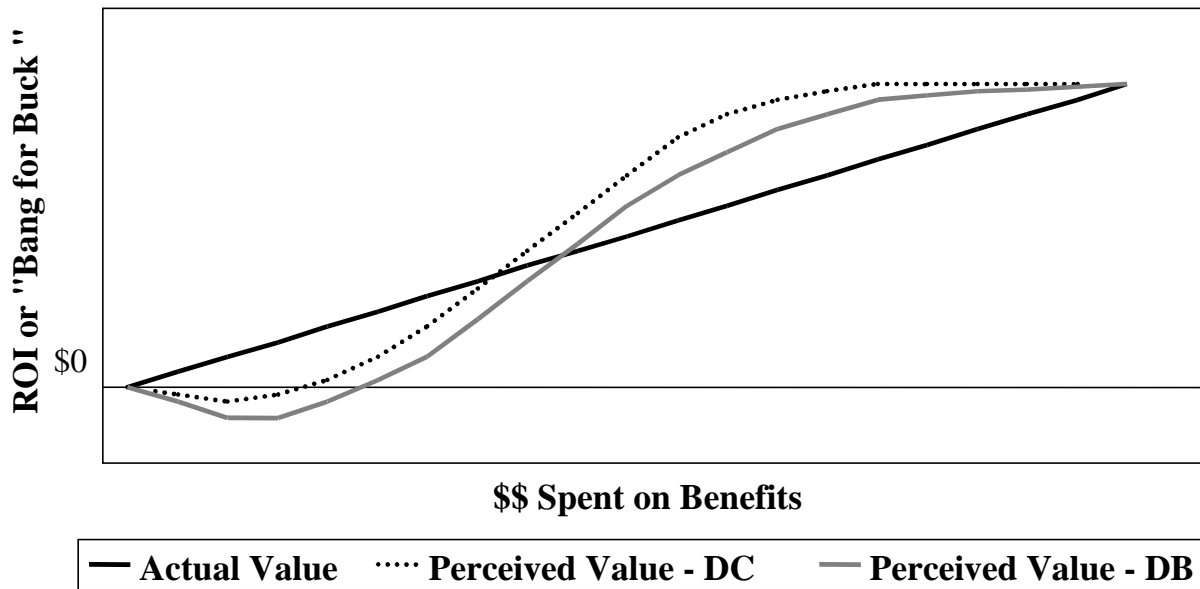


CHART 4
TRENDS IN DB AND DC—RETIREE MEDICAL

