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Legal and Actuarial Considerations in Modifying a Retirement Program

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Summary: This session provides an analysis of legal and actuarial issues which must be considered when modifying an existing retirement program. Panelists include discussion on some of the unique issues pertaining to the new "hybrid" plan designs.

Participants are exposed to expert views on retirement program considerations and are provided with sufficient time to pose questions to the panel.

Mr. William Torrie: We have Kyle Brown with us. Kyle is the retirement counsel for Watson & Wyatt Worldwide Research at their research information center in Maryland. He has been involved in the ERISA practice for about 14 years.

Mr. Kyle N. Brown: I'm an attorney with Watson & Wyatt. This panel presentation was supposed to be discussing a wide variety of topics dealing with legal and actuarial issues in modifying a retirement program. The issue that I specifically was going to address was the legal and actuarial issues involved in modifying a traditional retirement program into a hybrid-type program, cash-balance or pension equity type program.

The first topic I wanted to talk about was a case *Corcoran v. Bell Atlantic*. Bell Atlantic had an employer-sponsored, traditional defined-benefit plan. It was overfunded by approximately $5 billion. They then proceeded to what seemed to me to be a series of liability reductions and amendments. They kept trying to cut costs even further. I'm not sure why you're trying to build your excess assets over the $5 billion mark. They did two different amendments. They had an unreduced early retirement benefit available for individuals at age 55 with 20

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years of service. There was also an additional unreduced early retirement benefit available at age 60 with 15 years of service, but for reasons we don't need to go into, that particular early retirement provision was not part of the litigation; it was the age 55 and 20 years of service unreduced benefit. The benefit provided for a distribution of benefits in lump sums to be made to benefits under $3,500 only. It wasn't clear from the case whether or not this was an involuntary lump sum or a voluntary lump sum. The case reads as if it was a voluntary lump sum for benefits up to $3,500. With all due respect to our federal judiciary, not a whole lot of judges have a lot of experience in ERISA issues. So whenever I read that I always figure it probably wasn't an involuntary cash out and the judge, for whatever reason, didn't understand or didn't care. It was presented as a voluntary, but I think it was an involuntary. Additionally, the plan had three previous occasions of offers of early retirement windows that provided lump sums based on the entire accrued benefits. So there were window benefits in the past where unlimited lump sums were available, but as a general provision of the plan that was not an available option. Only the small lump sums were available.

There were then two amendments that proceeded to substantially change the plan and promote the litigation. First there was a 1991 amendment that increased the requirements for early retirement eligibility. That one year was added to the age requirements for unreduced benefits. It was added every two years starting in 1994. This then kept on until it was increased up to age 60 years by the year 2002. By the year 2002, the unreduced benefits would only be available if you were age 60 with 20 years of service. Additionally, the 1994 amendment converted the plan to a cash-balance plan. Both of these amendments prompted some major litigation. The cash-balance account was based on the accrued benefit on data conversion, converted using UP84 with no age setback as the mortality assumption and the Pension Benefit Guaranty Corporation (PBGC) rates. I believe it was the PBGC rates for the September prior to the conversion. They used Unisex Pension Table (UP84) and PBGC rates for the conversion.

The participants had three different claims. The first was that the change in the early retirement provision, in which they changed the age requirement from 55 to 60, phased up to 60. They claimed that violated 204(g) of ERISA, which is nothing more than the ERISA counterpart to 411(d)(6) of the code. We're all probably excruciatingly familiar with 411(d)(6) and its anti-cutback protections that it provides. The reason the participants based their claim on 204(g) was because a participant can't sue to enforce the terms of the Internal Revenue Code. Participants can't sue to enforce 411(d)(6). However, they can sue under ERISA to enforce the terms of ERISA. If there's a mirror provision, both in the code and in ERISA, participants always sue under the ERISA provision. That's why, in this case, the litigation was based on the 204(g) anti-cutback rule.

They also claimed that the conversion of their current accrued benefits to the cash-balance account should have been based on the actuarial assumptions that were used in the lump-sum benefits, the unrestricted lump-sum benefits available under the early retirement windows that were offered in the past. I'm sure the first question somebody would ask is what were those assumptions. The answer is I have no clue. We can presume, of course, that those assumptions would yield larger lump sums than the UP84 and the PBGC rates, but it's not specified in the case what those actuarial assumptions were.

The third claim is that the entire conversion of the plan from its traditional plan design to a cash-balance plan violated the fiduciary standards of ERISA. While the participants didn't claim that the decision to convert to a cash-balance plan violated fiduciary standards, they did claim that the way the conversion was done violated the fiduciary standards of ERISA.

Those are the three claims that the participants made. First the early retirement eligibility increased the age from 55 to 60 over a period of time. What participants were claiming was that if they hit age 55 and 20 years of service, that 204(g) protected them in such a way that they had to be able to get their entire benefit on the date that they hit 55 and 20 in an unreduced format. You couldn't cut back their currently accrued benefits, or any benefits that they might accrue up until the date that they hit age 55 and had 20 years of service. The court took a look at this and actually gave a really good discussion of what 204(g) and 411(d)(6) protects. It very clearly points out that it only protects benefits accrued to date. The participant has to be allowed to get the benefit that is accrued on the date of amendment in an unreduced form when he or she hits age 55 and has 20 years of service. However, you don't have to offer that in an unreduced form at age 55 and 20. You can change future accruals to require any eligibility requirement you want at all. The court didn't go through how that transition is made.

In the case at hand, let's think about the amendments that we had here. You're phasing up your retirement age one year at a time every other year, so on the first date, 1994, you go from age 55 with 20 years of service to age 56 and 20. Let's say somebody was age 40 and had 10 years on that date, so the benefit was based on 10 years of service. When they hit age 55 with 20, you’re going to have to offer the benefit that's based on 10 years of service as an unreduced benefit. For that participant, you could offer the choice between a 10-year benefit, a benefit based on 10 years of service unreduced or a benefit based on 25 years of service. A person who is 40 and 10 will have 25 years of service at age 55 and be completely reduced. The total benefit is full actuarial reduction to age 55. They can choose between the greater of those two and that will satisfy 411(d)(6). You then phase up yet another couple of years, and you can see that this is going to start getting much more complicated. In two more years, that person is going to have another benefit based on 12 years of service and has to be able to get unreduced benefits at age 56 and 20 years of service. In another couple years, he or she is going to have another benefit based on 14 years of service that he or she will be able to get at age 57 with 20 years of service.

I thought the plan amendment was such that the administration of it is going to be substantially complicated by having this graduated phase into the age 60 retirement age. It certainly is allowable. Maybe this is the conjunction of legal and actuarial considerations in modifying your retirement plan. Is what Bell Atlantic did legal? Absolutely yes. Is it easy plan administration? Not to my eyes. It sets up that you're going to have a series of transition benefits that you're going to need to track for everybody that's in the plan on those very different transition dates. It is going to be a fairly complicated kind of plan administration to get through.

The court then turned to the cash-balance conversion. I thought this was a really interesting discussion in the case. The court focused on the fact that the actuarial assumptions that the participants wanted were used in three early retirement windows, available in the past under the plan. All the windows had closed as of the time of the conversion to the cash-balance plan. The court went through all the IRS guidance on 411(d)(6) and what it relates to and the legislative history and came to a conclusion that I think we would probably all agree with. A window benefit is not a permanent part of the plan and if something is not a permanent part of the plan, then it's not protected by 411(d)(6) or 204(h) of ERISA. Since that was the case, the plan didn't have to use the window assumptions in converting to the cash-balance account, and as soon as it reached that conclusion, the court just stopped and moved on.

What I thought would have been a little more interesting is if they looked at the assumption that those lump sums were in the plan. I have to admit I don't know what the assumptions were, but even if the assumptions were a permanent part of the plan, my understanding is Bell Atlantic could have still done what they did. You can define the cash-balance account any way you want using any assumptions you want to use. You can start off with your initial cash-balance account as zero, as long as you provide grandfathered benefits equal to the accrued benefit in the plan on the date of conversion. So how do you do the transition to the new cash-balance account? I don't believe that conversion itself is protected by 411(d)(6,) but the benefits accrued as of that date are the ones that are protected by 411(d)(6). Depending upon what you're willing to do, you can define your conversion any way you want and then the participant gets the greater of the benefit based on their cash-balance account or the benefits based on their grandfathered benefit on date of conversion. That's an interesting point to keep in mind.

Finally, the court addressed the fact that the conversion violated the fiduciary standards of ERISA . The court discussed the fact that a planned amendment is not viewed as a fiduciary function; it's viewed instead as a settlor function. Plan sponsors are quite often plan administrators at the same time. You have to be able to figure out in what capacity plan sponsors are acting when they do a specific act. If they're acting as a fiduciary, then they're going to be subject to all the ERISA fiduciary standards, but if they're acting as a settlor, then those acts are not subject to ERISA's fiduciary standards. Designing a plan amendment, figuring out whether to amend a plan, figuring out when to amend a plan and figuring out what that plan amendment is going to say are all settlor functions and those are not subject to ERISA's fiduciary standards. This was fairly well established several years ago in the case of *Lockheed v. Spink*. It was a Supreme Court decision dealing with a plan amendment. Lockheed had amended its plan. It put in an early retirement benefit and a condition of getting that early retirement benefit was that a participant had to sign an Age Discrimination in Employment Act (ADEA) of 1967 waiver in order to get the benefit. That was part of the plan amendment. Mr. Spink claimed, because Lockheed was getting the benefit from this waiver of any ADEA claims against Lockheed, that the amendment violated ERISA's fiduciary standards and was a prohibited transaction. The benefits of the plan were being used to benefit Lockheed.

The Supreme Court took a look at it and said that to have a prohibited transaction, you have to have a fiduciary. The definition of a prohibited transaction states that if there's not a fiduciary involved, there's no prohibited transaction. Since the transaction was a plan amendment and a plan amendment is a settlor function, there's no fiduciary involved. Lockheed's amendment, in that case, was not viewed as a prohibited transaction by the Supreme Court. There was very clear discussion of the fact that plan amendments are settlor functions and not viewed as fiduciary acts. In the Bell Atlantic case, the court came to the exact same conclusion. Actually, they didn't spend a whole lot of time on this. You know things are going poorly for you if you are the litigant when the court says, “We shall first consider plaintiff's contentions under Section 204(g), which, as will be seen, requires extended analysis. We will then dispose of the relatively simple fiduciary duty claim.” You can anticipate that that one is not going to go in your favor. The court determined that the plan amendment that converted to a cash-balance plan was not a fiduciary act and did not violate fiduciary standards. The term on how that conversion was to be done was very clearly set forth in the plan amendment. The execution of those clearly set forth criteria and the execution of those criteria is a fiduciary act. If a plan tells you to do X, you have to do X. That's a fiduciary standard in the administration of the plan. But, if you do X, then you have not violated fiduciary standards.

From the Floor: You used a term I'm not familiar with, settlor.

Mr. Brown: *Settlor* is a word that is pretty well established in trust law, but ERISA trust law has, in some ways, only a passing resemblance to traditional trust law. It basically means non-fiduciary. One way of looking at it is when you are the sponsor of the trust, as the plan sponsor, you created the trust and designed the trust. Those are nonfiduciary acts. When you make those kind of decisions, they're nonfiduciary decisions. They are called settlor decisions.

From the Floor: Was a lot of the rationale behind the Department of Labor (DOL)'s use of that related to what fees could and could not be paid out of the trust?

Mr. Brown: That's right. The first time the settlor/fiduciary distinction was brought up was in a DOL letter to an attorney based out of California named Kirk Maldonado. The letter is commonly referred to in the industry as the Maldonado letter. Kirk wanted to know specific fees associated with specific acts, like what could be paid from the trust. He had a client that was going through a plan redesign and that client wanted to know whether or not the fees incurred in the design study could be paid by the trust. Could the fees incurred in amending and administering the plan be paid by the trust? All he wanted to know about was payment of fees. The DOL responded to the Muldonado letter. It said to figure out whether or not the fees can be paid based on whether or not it's a fiduciary function or a settlor function. That is, if it's a fiduciary function, then it's an expense that can be paid from plan assets. If it's a settlor function, then it's not an expense that can be paid from plan assets. The cost of drafting the amendment is a settlor function and cannot be paid from plan assets. There are expenses of administering or implementing the new design. Those are fiduciary functions so the administration or implementation fees can be paid from plan assets. Whether or not administration or implemention can be paid from plan assets or not was what the DOL used to come up with this distinction. The distinction really has much more far-reaching implications.

When you figure out what you're going to do with the plan or what a sponsor's going to do with the plan, it cannot be a fiduciary function. If it is, the fiduciary standards require that plans have to be administered to the exclusive benefit of participants. If that's the case, how can you terminate a plan? If the decision to terminate is a fiduciary function, how can the decision to terminate ever be in the exclusive interest of participants and beneficiaries? The fact that it's not a fiduciary issue is an essential element of sponsoring these plans. If people can't get out of them, or change them, or can't reduce benefits in the amendment, who will ever put one of these plans in?

Mr. Thomas Naffe Rice: Did the overfunded status have anything to do with the decision in the discussion?

Mr. Brown: It didn't in the *Bell Atlantic* case, although that is a segue into the *Jacobson v. Hughes Aircraft* decision. Hughes Aircraft sponsored an overfunded contributory plan. Mandatory contributions were required from participants in order to get the benefits and the plan was overfunded. I have to admit, I don't recall the specific amount of the overfunding, but it was billions, not just millions, so it was a substantially overfunded plan. Hughes Aircraft amended this plan to make a variety of different changes. One of the significant changes that it made was the fact that for new hires (individuals hired after the date of amendment), the plan was noncontributory. They were going to continue to get retirement benefits under the same schedule as existing employees, but they did not have to make contributions. Obviously, Hughes Aircraft was anticipating that it was going to fund this benefit with the excess assets that existed under the plan.

If this was a noncontributory plan, I'd have to assume that the court would take one look at this and *Lockheed v. Spink* issued by the Supreme Court a couple years before this case arose, and say the amendment to change the design is a nonfiduciary act. It would say you can change it any way you want. However, this was a contributory plan and the Appellate Court said that because ERISA sets forth different standards for treating benefits attributable to employee contributions, then different standards are applied to those plans. Of the three different standards that applied to contributory plans that the court mentioned was: first, benefits attributable to employee contributions are fully vested at all times; second, the rules on determining the employee-derived accrued benefit under 411(c) of the code state that you have to use 120% of the mid-term applied federal rate (AFR) to increase benefits each year in order to determine what benefit is attributable to employee contributions. If that benefit is somehow greater than the total benefit, they have to be able to get that. Third, and most important was the requirement that if you terminate an overfunded contributory plan, then the employees who made those contributions have to get a rateable share of those excess assets. In the event of plan termination, employees who made contributions have to share in some of the excess assets generated by their contributions.

The court said that because of those three different requirements, which are different only for contributory plans, amending a contributory plan is a fiduciary act. For example, in a plan termination, employees share in the allocation of excess assets. Because of that, amending that plan is a fiduciary act. I think that is a leap about the size of the Grand Canyon. They've just gone straight from A to B to C right to W. We just skipped most of the alphabet in there. I find the decision completely at odds with *Lockheed v. Spink*. There is nothing in

ERISA that would seem to indicate that the fiduciary standards applied differently to a contributory plan than they do to a noncontributory plan, including the fact that when you terminate a contributory plan, employees share in the excess assets. If terminating the plan is a fiduciary act, how is terminating the plan to the exclusive benefit of participants? If you can't terminate a plan, then why do we even have the rule that requires that excess assets be allocated to participants? To me, it sets up kind of some loop where you keep going back and forth. You can't terminate, but if you do terminate, you get your excess assets, however, if you share excess assets, you can't terminate. It just doesn't work well for me.

The good news is that the Supreme Court has accepted *Jacobson v. Hughes Aircraft* and it will be deciding it this year. Hopefully we will get a final determination on this case. There are a number of different organizations that have filed briefs with the Supreme Court on this case. One thing that's interesting is that several organizations have filed briefs and don't care what the decision is; they just want a clear answer about what these rules are. *Lockheed v. Spink* evidently didn't cut it, but you need to tell us what are the fiduciary standards in amending the plan.

The next issue I want to talk about is the NationsBank plan. NationsBank has been getting a lot of play in the recent trade press. I hope that most of you have seen some of the documentation about this new plan that NationsBank has put in. NationsBank had a traditional defined-benefit plan and they converted it to a cash-balance plan. This has to be viewed as an absolutely cutting edge cash-balance plan design. NationsBank has 11 different investment options, and the participants can choose what their investment rate is going to be under the plan.

Mr. David Rosenberg: Has there been any discussion at all about the implications that this will have on defined-contribution plans? There are employee contributions involved in defined-contribution plans but they're not mandatory. Is that an issue at all?

Mr. Brown: I haven't heard anybody bringing up any issues about defined-contribution plans. There certainly can be mandatory contributions in a defined-contribution plan. I don't know why you couldn't have a contributory money purchase plan. It depends on how you want to look at a 401(k) plan. You could view a 401(k) plan as a mandatory employee contribution plan. That is certainly the way the DOL would like to view the 401(k) plan. It's also very clearly not the way the IRS views it, but if we're talking to the DOL about fiduciary standards, we are talking to the most significant government agency.

From the Floor: While we're on this subject, the question that occurs to the amateur is if I'm trying to do a settlor function that somehow dilutes the value of participants, that begins to sound like it ought to be a fiduciary funding.

Mr. Brown: It depends on what you mean by dilute the value.

From the Floor: It means to cause my value to be less in any way whatsoever. You can argue that that's cured if we're going to terminate it; we're going to divide things fairly according to the rules.

Mr. Brown: Right.

Mr. Torrie: Let's suppose you had an overfunded contributory plan, and because it was overfunded, the employer used the overfunding and reduced the contributions. It doesn't even have to be a plan amendment.

Mr. Brown: In some ways, it still depends on what you mean by dilute the value. For example, let's say a benefit accrued to date cannot be reduced. The accrued benefit the participant has accrued as of the date of an amendment cannot be reduced or eliminated because of 204(g) of ERISA. For example, let's say you have a 2% of final pay plan, traditional plan, and you're going to amend that plan to convert it to a 1% of final pay for all service plan, so that any benefit accrued on the date of change is protected. Under that example, large groups of participants are going to accrue nothing for a long period of time. If you consider that the ability to freeze benefits entirely or to terminate the plan is within the settlor's power, and that you have somehow reduced their future or their value by changing their rate of accrual or changing the funding mechanism slightly, then those changes are absolutely fine as long as all the changes are still within the perimeters of ERISA.

From the Floor: Suppose there is a change. If we terminate today, I would receive *x*.

Mr. Brown: Right.

From the Floor: But instead they take some action which causes the money to be paid out in another way, and I don't get a share of that money.
Mr. Brown: You get less than *x*?

From the Floor: Then they terminate and I get less than *x*. That's what I mean by dilute.

Mr. Brown: Obviously that's a very troubling hypothetical case, but I think that's really going to depend on what the action that they take is. For example, let's say you have a benefit equal to *x* and you have assets to cover *x,* and they merge in an incredibly underfunded plan. They're allowed to do that, but there are rules under 414(l) of the code that when you do that, you have to set up schedules on how those assets are going to be allocated. If you merge in that underfunded plan and they terminate soon after, there still should be assets available to cover your benefits. You have to set up the schedule in order to bring that in. If we're talking about some other kind of plan amendment that tremendously increases benefits for other employees, so that the plan liability skyrockets, but assets don't, you still have to get benefits attributable and you still have to get a distribution equal to *x* from the plan.

From the Floor: As long as the money is there.

Mr. Brown: Yes, as long as the money is there. If the money's not there, then the employer has to be able to go through a distress termination with the PBGC. This is one of the more unpleasant things that can go on in your professional career. There are also very strict limitations on when you can do that. You can't just decide you’re going to do a distress termination. The company has to be in financial distress. Unless the company is going under, you can come up with a fact pattern that on one day you might have a benefit equal to *x* and assets necessary to cover it, and on some later date, there are not enough assets to cover it, but I think the facts that we would have to create such a domino effect would have to be available.

Let’s discuss NationsBank cash-balance plan and investment credits. We'll start with a traditional description of the cash-balance plan that it allows for compensation credits. There are going to be increases over time based on investment credits available under the plan. However, they offer 11 different investment credits in rates under the plan and the participant is allowed to choose which of those investment credits will be used to increase their benefit. Additionally, the participant is allowed to choose that investment credit rate on a daily basis. There is daily switching of investment crediting rates available under the plan. Additionally, participants are allowed to take loans from the cash-balance plan, and if they do take a loan, it essentially creates a 12th investment crediting rate, so that the interest that the participant pays on the loan is credited to the individual's cash-balance account and becomes an interest crediting rate for that portion of their benefits.

One other feature of the plan is that principal is guaranteed against loss. For some reason, I have yet to find a nice, simple way to describe this so that everybody gets it. I'll probably describe it two or three ways, and if you don't get it, please let me know. Cumulative compensation credits plus the transfer amount are guaranteed against loss: your benefit can never be less than your cumulative compensation credits. What that does mean is you can have a negative investment crediting rate in a year. If you've been in the plan for a long time, and you have had a significant amount of investment credits go to your plan, or if you've had a run up from a bull market, you can have a negative rate in a year, but only to the extent that you have had positive investment credits added to your account. So investment earnings, in essence, are at-risk, but your principal and compensation credits are not at-risk and can never be reduced because of investment loss.

Finally, one other feature that's available under the plan is a one-time election that NationsBank is allowing its participants to transfer their 401(k) plan account balance to the NationsBank cash-balance plan.

From the Floor: Why would you do that?

Mr. Brown: Do you mean the participant or the NationsBank?

From the Floor: The participant for openers.

Mr. Brown: The participant would do it for two reasons. If you look at it from the participant's point of view, you'd see that the operation of this plan is identical to the 401(k) plan. The investment options are the exact same investment options under the 401(k) plan. Once that money is in the cash-balance account, it grows based on your elections of the exact same investment accounts, and you'll have two additional benefits.

Second, they gained the PBGC guaranty. Basically, it works exactly the same as the 401(k) plan, plus it has a guaranty of principal and the PBGC guaranty. Why would NationsBank be interested in doing this?

NationsBank is betting that their employees are lousy investors. NationsBank is betting that the employees are going to have conservative asset mixes and earn a rate of return that is less than the actual rate of return. That's probably not the main reason NationsBank put this in the plan. I have seen the communication materials and part of it does look a little bit funny. The 11 different investment options are all NationsBank mutual funds. The bank very clearly indicated that it is banking on the plan earning more money than the participant allocations. What they're saying is that the money manager for the pension plan is going to outperform the money manager for the mutual funds, all of whom are NationsBank employees. It's funny that way. That obviously is not what they're saying and not what they're planning on. What they're planning on is having a different and more aggressive asset mix, so that the asset mix of the plan will outperform the participants' asset mixes.

If you assume that the plan is going to earn a higher rate of return than the participants earn, then this becomes a cheap plan. One example would be the total participant transfers from the 401(k) plan to the cash-balance plan. Let’s say the participants transfer $75 million of assets from the 401(k) plan to the cash-balance plan. I wouldn't be surprised if, based on NationsBank’s assumption of what the plan's going to earn, that they book it as a $60 million liability. NationsBank believes that over the period of time, they're going to earn enough excess interest rates in order to cover that $15 million spread. That's why NationsBank would do this.

Mr. Torrie: In effect, what the plan sponsor is saying is that the individual will have a different investment horizon. If he gets near retirement, he's going to go into more fixed income, whereas the plan has a longer investment horizon and they can still stay in the riskier investment.

Mr. Brown: That's a very good point.

Mr. Torrie: They are operating as an insurance company.

Mr. Brown: Yes. There are several reasons why the asset mix of the plan should be different from the asset mix that the participants choose. The fact that the plan has a longer investment horizon is one of them. The other one will hopefully be that the plan money manager is making more skilled judgements on what that investment mix should be.

From the Floor: One thought has occurred to me. One of the big focuses in the last couple of years with 401(k) plans has been to educate employees. Much of the emphasis of that education has been to encourage employees to invest more aggressively and that has caused the money to move out of the guaranteed investment contracts (GIC) type products into the equity products among other things. The employer has had an incentive, if you will, to encourage people to invest intelligently and more in the equity market, because that would produce adequate retirement benefits in the 401(k) side. The way you have described it, it sounds like you're creating an adversarial position between the employer and the employee—an incentive, if you will, for the employer to encourage the employee to invest more conservatively and not in his own best interest.

Mr. Brown: I have several thoughts. The first one pertains to the history of participant direction. Somehow, it had become an accepted wisdom in the firm that a professionally managed plan would outperform a participant's directed plan by somewhere in the vicinity of about 2–3% a year. We went back and looked at investment rates of return for the S&P 500, and for plans in the early 1980s. It really looked like a professionally managed plan was outperforming the S&P 500 by 2–3% a year. The first comparison was done in the very late 1980s. The professionally managed plans outperformed by 2–3%. In the mid 1990s, we saw that the gap narrowed dramatically. Professionally managed plans still seem to out-perform participant-directed plans, but by only about 1%.

The reason we have to assume that that gap has narrowed is of course as we've said, employers and consultants have spent an enormous amount of energy and time and money over the past decade in doing exactly as you said—trying to educate participants in the proper way of investing their funds. The other thing that the survey indicated was that asset mixes, based on the different age cohorts, were actually something that gives you a little hope for the future. Participants who were age 50 to 55 or older, were substantially in GICs and participants who were much younger, who had the longer investment horizon, had a much more aggressive equity-based asset mix. The message was getting through and part of the reason for the difference in performance probably is attributable to the fact that a sizeable population in your work force that's nearing retirement is going to be more invested in GICs. They're going to be earning a lower rate of return than your younger workers. If you have a professionally managed plan, people are investing in plan assets as a whole. Then that plan has a very long-term horizon and the ratio, or total plan assets invested in GICs is going to be much lower. Actually, at least part of the 1% gap between the two can be explained by the different investment horizons that the different investors are taking a look at.

The other point that your comment raised was the adversarial issue. I think you're right that there is potential for that kind of adversarial issue to exist, but NationsBank has taken great pains, some of which you may agree with and some of which you might not, to try to not create that. First, it is trying to encourage aggressive investment elections by having a guaranty of principal. If you know your principal is always protected, then you very well may be choosing a more aggressive asset mix than you would if it is not. Second, one of the things NationsBank is trying to honestly communicate with this plan is that the plan rate of return is expected to exceed what the participants come up with. It is communicating this as a good thing for participants. There is that discrepancy, because the plan is earning additional assets that don't have to be allocated to the cash-balance account. The plan is going to cost NationsBank less. So NationsBank's financial statement is going to benefit from this plan. I think there is a comment in the communications that states that's going to be coming back to you in the form of additional bonuses. I have to admit that's a little hard sell, and I'm not sure I would go with it.

From the Floor: It seems to me that to extent the principal is guaranteed against loss and if there's a market crash, the plan puts the claim in on the PBGC.

Mr. Brown: NationsBank has obtained an IRS determination letter stating that this plan satisfies the qualification requirements of the code. The determination letter has nothing to do with PBGC coverage. This plan is covered by the PBGC. Nothing the IRS can say or do is going to change that. Your point about a market crash is well taken. Let's not forget the recent merger. I think the historical symmetry to Bank America is so irresistible. The very first cash-balance plan was established 15 years ago by Bank of America. Now we have the new blood, with its cutting-edge design established by NationsBank which is now Bank of America. We've come full circle.

From the Floor: Can you give us information on the funding status of the pension plan? What was it like before the change and after the transfer of the 401(k) balances?

Mr. Brown: No, I can't. I don't know.

From the Floor: I would guess that it is probably overfunded. It is important.

Mr. Brown: I wouldn't be surprised, especially after the transfer. If we have a market crash so that this plan creates a liability that goes on to the PBGC, that means for that to happen, not only does the plan have to terminate, but Bank America has to go out of business. This plan is going to be a minor point if we have that large a crash to cause that kind of a financial institution to go out of business. I think this additional liability put on the PBGC will not make the top 20 list of concerns of the federal government.

Mr. Torrie: I have two thoughts, one with regard to the scenario you just mentioned and it's a certain risk with the cash-balance plan. If the sponsor of a cash-balance plan goes out of business, perhaps because of some investment situation, and at the same time the market value is going to be down on its assets, the sponsor may be forced to pay out a lot of lump sums because there are a lot of people leaving. It is unlike a typical annuity pension plan where they could defer that. Second, does this particular plan allow rollovers for new employees?

Mr. Brown: I believe we do.

Mr. Torrie: Then let’s take an example of twin employees, both with 30-year careers. One is with NationsBank and has been in this plan for 30 years. He has $100,000 in his account, but his guaranteed amount might be something like

$20,000, whereas the new employee comes in with a rollover amount and there is a guaranteed principal of $100,000. There might be a certain inequity that may not immediately be apparent, but somewhere down the road it might have to be addressed.

Mr. Brown: Right.

Mr. Joshua David Bank: They're not guaranteeing that one-time transfer as well are they?

Mr. Brown: Yes. If you transfer your $100,000 401(k) account, it becomes a $100,000 cash-balance account that is guaranteed against loss. What you have is competing interest. There is potentially a pretty severe financial obligation that the company may be taking on. They started this design and I believe actually submitted the determination letter request back in January 1997. In January 1997, this looked like a great idea, but the conversion was actually effective in July 1998. In July 1998, I'm not sure they necessarily would have made exactly the same choices. One issue is the potential financial obligation on the employer. The other one is I think NationsBank really is trying to communicate this as a win for the participants. It avoids that kind of adversarial relationship between themselves and participants.

Mr. Roger F. Ray: Did NationsBank substantially adopt this approach, get it approved and have it in place prior to this Bank of America merger?

Mr. Brown: Yes.

Mr. Ray: A follow up, what kind of plan does Bank of America have and what will happen next? Will there be a merger of these plans?

Mr. Brown: Bank of America has a cash-balance plan. It has the first cash-balance plan. What they plan on doing with the potential merger of these two plans is unknown at this point. I don't know if the bank has decided. If it has, they certainly haven't communicated it. The future of the two different cash-balance plans is unclear.

From the Floor: I don't know why somebody would transfer from 401(k) to the defined-benefits (DB) plan or the cash-balance plan. I don't know what the payment options were and if those were addressed. The 401(k) might have just had a lump sum. Once you put it in the DB plan, there might be many other options and also the joint-survivor requirement.

Mr. Brown: I believe the 401(k) plan only offered lump-sum distributions. The cash-balance plan also offers unrestricted lump-sum distributions based on your cash-balance account balance at the time of distribution. It also offers all the other traditional annuity options available under the plan. In addition to gaining the principal guaranty and the PBGC guaranty, you're also gaining the potential to have an annuity payout, a much better retirement income planning tool for the participant.

Mr. Torrie: Several cash-balance plans are designed so that at retirement you're allowed to rollover your savings plan account to the cash-balance plan and then convert it. In several cash-balance plans, the conversion is done at subsidized rates. It's using a higher interest rate so you get a slightly larger annuity than you could actually go out and buy. It is perhaps another risk that should be considered when valuing a plan.

Mr. Brown: Let's talk about the 401(k) transfer element again. The topic we were supposed to be discussing was issues involved in modifying the plan. The main issue involved in modifying this plan from a traditional DB plan to the new cash-balance design is this transfer of the 401(k) account balances into the cash-balance plan. When that 401(k) account balance is transferred into the plan, it's converted into a cash-balance account. The issue here is whether or not this transfer is going to satisfy 411(d)(6), which protects optional forms of benefit against cutbacks, but does not allow you to eliminate an optional form of benefit or a protected benefit by plan amendment. IRS regulations indicate that the individual account feature of a defined-contribution plan and the guaranteed benefit, the defined-benefit feature of a defined-benefit plan, are protected benefits. If you can't eliminate the individual account feature by plan amendment, you can't eliminate the guaranteed defined-benefit feature by plan amendment.

How do you convert money of one type to money of the other type without violating 411(d)(6)? The main way we do this is through elective transfers that the IRS regulations provide for. Two of the most notable ones are when you have to get participants and sometimes spousal consents to the transfer. Benefits are transferred from a plan of one type to a plan of the other type and they're converted to the other type of money. That's fine. One of the key criteria for doing the elective transfer is that benefits have to be distributable from the transfer or plan. In this situation, that would require that benefits be distributable from the 401(k) plan. As we all know, there are distribution restrictions on the 401(k) money. You can't make a distribution from a 401(k) plan to an active employee who is not disabled or doesn't have a medical emergency until that individual is age 59½ . You can't offer a wide-spread elective transfer from a 401(k) plan to a defined-benefit plan and satisfy 411(d)(6).

The question is, how do they satisfy 411(d)(6)? The argument is ingenious. This cash-balance plan looks so much like a defined-contribution plan, it's an absolute mirror image of the NationsBank 401(k) plan. There is no elimination of the individual account feature when you convert this money to this cash-balance account. In the 401(k) plan, it was going to grow based on 11 different investment options, subject to daily switching by the employee, and the cash-balance plan is going to grow by the same different 11 options, subject to daily switching by the employee. The growth of the cash-balance plan and the benefit payable from the cash-balance plan is going to operate identically to how the growth and the operation of the 401(k) plan would operate. Therefore, there is no 411(d)(6) cutback under the code.

I'd buy that argument from a participant's point of view. To a participant, this plan looks so much like the 401(k) plan that the only differences are the ones we've already identified. There is guaranty of principal and the PBGC guaranty. The only differences are things that benefit the participants. So why would a participant be worried about 411(d)(6)? The harder question is does the IRS think that this satisfies 411(d)(6)? This is the point where I give one general comment on the NationsBank cash-balance plan. I have to admit that I am just a heartbeat away from being flat out envious. This is a creative plan design. This is very ingenious kind of plan design. Should this plan design be part of our national retirement income policy? I understand that there are pros and cons and financial obligations being taken on that you can argue with. Should this design be part of our national retirement income policy? I think the answer is yes, it should.

Does this plan design meet existing IRS guidance on cash-balance plans, and does it meet currently articulated IRS enforcement policies? That is a much harder question. Whether or not the IRS is going to sign off on all this is a much more difficult call to make. NationsBank has a determination letter. First, the IRS legally cannot retroactively revoke the determination letter. NationsBank has a determination letter, the conversion has taken place, and transfers have occurred. The determination letter should cover all that. Things that have happened to date can't be changed retroactively. Prospectively, the IRS could legally revoke that determination letter, but what would be the basis? They changed their minds? If they did that to a mom and pop grocery store's defined-benefit plan that's one thing, but that the chances of that happening to Bank of America's plan, especially given current IRS relations with Capitol Hill, are extremely slim. Having the IRS revoke the determination letter seems to be a long shot right now.

There are a wide variety of things that could happen in the future. One issue could certainly be that the IRS has been working on comprehensive cash-balance guidance for quite some time, and it seems to be having difficulty coming to grips with what will work and what doesn't work for cash-balance plans. There's actually still some conjecture over whether everybody at the IRS still thinks cash-balance plans are okay at the very basic fundamental level. Not everybody agrees. They're having a hard time coming up with cash-balance guidance. What's possible is that this is going to stir the IRS so that it sees that the market isn't standing still. People are putting in plans, things are happening, and the IRS needs to determine what the rules are.

Mr. Richard E. Burke: Take a situation where an employee had a terminated vested benefit and later returns to the company, but after the amendment to the cash-balance plan has taken place. They're trying to earn back their past service credits. When the cash-balance plan is set up, it assumes they have no prior credit, so they start with a cash-balance of zero.

Mr. Brown: But they still have a terminated vested accrued benefit, and they still have a benefit payable to them under the plan.

Mr. Burke: That's right. Now the question is as their cash balance has to move forward with their interest credits and their compensation credits each year, they are not seeing any movement towards this sort of cliff accrual that they're going to get when they earn their past service credit.

Mr. Brown: I'm not sure I'm tracking what you mean by past service credits. Let's say the individual has a vested age 65 annuity benefit of $1,000 a month. He comes back and he has a cash balance of zero. What past service benefit is he working to earn?

Mr. Burke: What if you want to combine the benefits? This person has a five-year credit. He now has ten because he’s worked the five years he needed to get the prior five that he had.

Mr. Brown: You mean like for early retirement eligibility?

Mr. Burke: Right.

Mr. Brown: Sure.

Mr. Burke: The question is, when would the cash-balance plan or the account actually see that increase in value or would it never come into play? It would only be in terms of figuring out what an early retirement might be?

Mr. Brown: I think the answer to that is really going to come down to what the employer chooses. It’s an employer design issue. If the employer wanted to be as absolutely cheap as possible and not give anything, I think they could start the individual off with a cash balance of zero and then their cash-balance account is only whatever their compensation credits and interest credits are that they earned after they were rehired. Any additional service will obviously count towards the person's eligibility for early retirement on the prior benefit—that $1,000 annuity. Once he or she gets the additional five years, he or she becomes eligible for early retirement. That would mean that the participant could get as little as the greater of that $1,000 benefit with the early retirement provisions or whatever the cash-balance plan account balance is after five years of service. The end result would be that the participant could work for five years and come out close to no additional benefits. That would probably strike most of us as pretty unfair, but I think it would be legal.

Mr. Burke: A slightly different question. Is it common to make a distinction between giving service credit for years worked versus giving the compensation credit accrual? For instance, under some termination provisions the employer may say you will receive service credit for the time that you're receiving severance benefit. However, the employer will not be making a compensation credit to your account after your date of termination. Is that common?

Mr. Brown: Is it common to have the interest credits continue after termination when compensation credits cease?

Mr. Burke: That's right. In terms of whether a person qualifies for an early retirement benefit based on age plus service reaching some cut-off point. The employer is saying, "We're going to count this service during the severance period for the early retirement rule, but we will not make a contribution to your account."

Mr. Brown: First, I would say that it's extremely common to have the interest credits work the way you described. The compensation credits will obviously stop when the individual terminates employment. If you have no more compensation, you get no more compensation credits, but interest credits continue to accrue. However, when you're calculating service for early retirement eligibility, most plans define that in terms of years of service with the employer. Once you've terminated, you no longer have service with that employer. The fact that you are getting additional interest credits under the plan is not viewed as causing additional service to be credited under the plan. Generally, only the active service with the employer is going to be counted.

Mr. Burke: Consider when a person reaches, say, a rule of 70 to be eligible for some special early retirement factors. The employer says as of the date you terminated you didn't, but your severance package gives you two years worth of compensation, which we're going to pay out over two years. Then we'll give you that service credit for the purposes of your age plus service equaling 70. We'll take your cash balance, and we'll use the accrual rate that we guaranteed. Move that up to age 65. Here is your benefit at age 65 and now we'll apply these additional factors to reduce it for early retirement. What happens is you're getting service credit for say two years after termination.

Mr. Brown: Right. Both for benefit accrual and early retirement eligibility potentially.

Mr. Burke: That's not right, because when they made the amendment to the cash-balance plan, they had a specific rule stating how your accrued benefit will be turned into a cash-balance account. Going forward, there would be compensation credits and interest credits to that account. They are making a fine distinction. They're saying, “During severance, we will not make compensation credits to your account; therefore, on the day you terminate, there will be a theoretical interest accrual to age 65.

From the Floor: When they say what is the total service in the situation, they include those two years as severance benefits. Even though you weren't an active employee, they include those years in your service. However, it doesn’t make it into the accrued benefit in terms of years of service times 2%.

Mr. Brown: The question is, is that legal and how common is that? It definitely is legal to do what you just described. You certainly can do it that way. How common is it? Employers spend a lot of time and effort in figuring out how to do a transition benefit for employees when they convert from a traditional plan to a cash-balance plan. They spend a lot of time and effort in figuring out how to do that transition and address many of these same kinds of issues. They usually spend almost no time figuring out what kind of transition rules are going to apply to terminated vested participants who are rehired. They don't think about these participants. I had somewhat similar fact patterns, at least two that I can think of right now for clients. There are a lot of times where terminated vested participants come back. What kind of service rules do you use? I It always comes down to a case-by-case issue.

The 204(h) notice is a requirement under ERISA that says that if you're amending the plan to reduce the future rates of benefit accruals, then you have to give a notice to participants 15 days prior to the effective date. This may go back to a question we had earlier about fairness and whether you are reducing future values. You do have to tell them that you're going to be reducing their rate of future benefit accrual. There's nothing they can do about it except quit, but you do have to tell them that you're going to be reducing their rate of future benefit accrual.

One issue that is asked by participants is, ”Does my conversion from a traditional defined-benefit plan to a hybrid plan, either a cash-balance or a pension-equity plan, reduce the rate of future benefit accrual? The answer to that question almost always depends upon what kind of transition benefit or transition rules you're going to put in when you make the conversion. Let’s say on December 31 you have a traditional formula and on January 1 you go to a new cash-balance or pension-equity formula with a protected benefit based on prior accruals. Then clearly you are going to have a substantial portion of the population that has a reduction in the rate of future benefit accruals. The pattern of accruals and the economic value that's accrued is different in hybrid plans than it is in traditional plans. In essence, that's part of the reason why you want to put these plans in. You're trying to get a different pattern of accrual. One thing it usually means is the rate of accrual for older, longer service workers is going to go down. There's going to be a reduction in that rate of accrual. If you don't do a transition, you'd have to give the notice. Everybody does a transition. There's always some kind of transition benefit that you put in. Do you have a substantial reduction in the rate of future benefit accrual that would require a 15-day notice. Everybody's trying to figure out whether he or she has to give the notice or not. My answer is very consistent. Who cares? Do it.

If you are making a fundamental change in the design of your plan, you are going from the traditional design to a new plan design; it is either a cash-balance or a pension-equity plan. I don't care if there's a legal requirement. You need to communicate that to employees. You need to communicate to them why you're doing it. Since the notice requirement doesn't have to include the words that your rate of future benefit accrual is being reduced, you don't have to say those magic words, you just have to describe what's happening under the plan. My response is do it. Just tell them what you're trying to accomplish.

From the Floor: Our company changed from a traditional defined-benefit plan to a cash-balance plan, and it was a bust. The company didn't do a 15-day notice, because it believed it didn't have to. Unfortunately a few months later there was kind of a 15-day notice, but it was a letter from some of the participants to the *The Wall Street Journal*. As the ultimate result of that, they kept the old formula as well as the new cash-balance formula. If they had sent out the 15-day notice in the first place, they would have lost the chance to save all the money that they ended up not saving anyway. There can be a reason. Perhaps you advertised to your employees that you're cutting their benefits substantially. If it weren't for the fact that we have actuaries and people that understand this stuff, it would have just gone right over our heads, and I'd be getting half the pension that I'm going to get now.

Mr. Brown: I guess the lesson is you should do it anyway because you're going to get caught. The 204(h) notice does not have a whole lot of litigation or guidance. All the litigation is clearly pro-participant. The fact patterns make you cringe. When in doubt, just give the notice.