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Plan Design Issues: The Corporate Perspective

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Summary: Panelists discuss the issues considered by corporate sponsors in making decisions regarding the design or redesign of retirement programs, including: The impact of plan changes on the corporate financial statement and how to use retirement programs to achieve corporate goals, including downsizing.

Mr. William Torrie: The first speaker is going to be Ken Cohn. Ken is a CPA and a benefits director for Southdown, Inc. The second speaker will be Eric Lofgren. Eric is the global practice leader for retirement plans for Watson Wyatt Worldwide. Eric has been around in this business for 25 years.

Mr. Kenneth D. Cohn: I want to give you the rationalization of benefit plans. Southdown is a cement manufacturing company. In March 1998 we announced a merger with Medusa Corporation, which is another cement manufacturing company. Now, together we have 12 cement plants. We have extensive ready-mix concrete operations, and we also have aggregate operations.

First of all, I would like to go into a little bit about—at least from the corporate perspective—the philosophy of benefits. There's probably a number of thoughts and ideas about why a company provides benefits, and I've characterized them by these particular items. What is mine is mine, and what is yours is mine. I'm sure a lot of employees don't really know how benefits ever came to be, but you can believe that they think every benefit is a vested benefit. They think it's a vested

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

right. They think it goes with the job. Now the kind of argument I would make to that is that you all know what *Financial Accounting Standard (FAS) No. 106* is. Retiree medical at one time was assumed to be a vested benefit. Well, companies, in order to survive, changed that idea, so it can't be that benefits are a vested right. It just can't be. That's not why we provide benefits. There is this paternalistic (or maternalistic) idea that management wants to take care of their employees. With the maternalistic/paternalistic idea of benefits, we want to take care of employees. I would ask of anybody who has ever been through right-sizing or reengineering or whatever, what happens to that paternalistic idea? The loyalty is not there, is it? So the idea of paternalism can't be the reason why we provide benefits.

Another reason may be the idea that you can do it better than I can. There's no doubt that a company is better able to purchase group benefits more efficiently than the individual. What if we have about 3,600 employees? What if each one of them had to go out and arrange his or her own medical plan? That's not very efficient. So it is true that it's more efficient for a company to provide benefits on a group plan, but that can't be the total reason because there are a lot of group benefits that companies don't provide. It may be group legal. It may be group long-term care. There are a number of things that companies don't provide. So what could be the reason? There may be one other reason, maybe *the* reason: because we have to.

When you think about it a moment, the reason that any company does anything for its employees is because the company has to do it in order to survive. The company is trying to gain some sort of competitive advantage. When you have a labor-intensive organization, and you are all involved in labor-intensive organizations or service organizations, it's critically important that you give your employees the proper incentives. Benefits are nothing more than a component of compensation. If we could get our employees to work for free just because they liked their jobs, we'd do it, but you don't work free for your employer. I know you all like actuarial work, but you don't do it for free. You have to be compensated for it. So it's the competitive advantage that companies are trying to achieve. That's the reason why they provide benefits. Now this competitive advantage does not necessarily mean that you're just trying to match whatever your competitor has. If that were the case, in time all the benefits would look exactly the same across companies, but they don't.

There may be broad functional categories that companies provide, but the benefits don't look alike. They're different in specifics. Of course, that's one of the problems that we had in this merger—trying to rationalize those differences in the specifics. Ideally, in order to gain the competitive advantage your company would like to have, you should structure your compensation, which includes benefits, in such a manner to induce you to produce one more unit of value, however you

measure that value—but also to induce you to produce one more unit of value than your competitor. That's meeting and beating the competition. That's gaining a competitive advantage. That's really the reason why we do this. If a benefit does not do this—if it does not favorably affect the bottom line—then what's the reason for offering it? If there's no advantage to the company in offering it, why do it? Companies give careful consideration to this—to the cost impact, the impact on profitability, and the impact on employee productivity—and we're facing those very issues today in integrating the Medusa benefits into Southdown. Why should we provide this benefit as opposed to some other form of benefit?

Certainly you as an actuary have a role to play in this, but I would suggest to you that it is not the role of merely working with actuarial tables, mortality tables, present values, morbidity, or any of the like. It certainly involves that, and you should not leave those things undone, but in order to really help the company gain this competitive advantage, you really have to partner with the company. You really have to understand the company's business, its strategy, and its culture. You have to understand all these things to really give that employer a competitive advantage, as well as to increase your value and, of course, the amount that you're able to charge an employer. Face it, you're in this business to be able to make money. You have to be able to provide that employer with some sort of advantage. Anybody can run an actuarial valuation, but to make money at it you have to be able to give the employer a competitive advantage.

In the merger itself, we really have two different sets of plans, and, as I said, we have the broad, functional categories. We have a health plan. They have a health plan. We have a pension plan, a defined-benefit (DB) plan. They have one. We have a 401(k). They have a 401(k), and so forth. But they're different. They're different in specifics, and we have to rationalize those. Of course, we employed actuaries extensively in evaluating these plans and the impact that they would have on the bottom line, and we made decisions based on that.

Suppose for a moment that you are going out to one of our aggregate quarries, to one of our truck facilities, to explain the Medusa DB plan formula to a quarry worker. Say a guy comes to you with 30 years of working in busting rock, and he says, "I want to retire. Could you explain my benefits to me?" You explain the formula to him. He says, "I think I'll work another five years." You can't explain the impact of that to him. He is not going to understand that. The Southdown formula is difficult enough to explain. The Medusa formula is nigh impossible. For that very reason, we knew that we had to change that. Their formula was not an option. It just so happened that the two formulas produced somewhat similar age 65 benefits. The Southdown formula produced a little bit higher. That assumes that the wages, years of service, and what-have-you are similar. The Southdown formula

produced just a little bit higher age 65 benefits, but the Medusa formula produced a higher age 55 benefit. The differences at the extremes are because of the early-retirement reduction factors inherent in the Medusa formula, and I think they converged at about age 61. So now we have a difference. The Medusa formula has a higher subsidy at age 55 than the Southdown formula. What we wanted to determine was, does this make a difference? Does the higher subsidy in the Medusa formula induce people to retire earlier?

We did an experience analysis of both the Southdown plan and the Medusa plan, and it turned out that even though the Medusa plan had a little bit higher subsidy in it, Southdown people were retiring just a little bit more frequently than the Medusa people. That's kind of counterintuitive, but we determined from that finding that probably this difference was a difference that did make a difference. Why is that? Well, there are a number of factors. The paycheck is always bigger than a pension check, and it's pretty tough for these individuals to be without that paycheck. Also, Social Security can begin early, at age 62, so we saw a big uptake in retirements at age 62. We believe that it was the reasoning of the individuals that they wanted to shorten the period of time between their retirement and when they could get Medicare. The Medusa people could retire with retiree medical at age 55, but it was at a very, very low level. It didn't pay much. In Southdown you could not get retiree medical until age 62. We believe that both groups were delaying retirement in order to ensure they would get retiree medical. We also analyzed what it would cost Southdown if we put everybody on the same early-retirement reduction factors as the Medusa employees had. Our *FAS No. 87* cost would have been increased by about $1.2 million. Again, this is for, as I call it, a difference that doesn't make any difference. Why incur that cost? So we decided not to do that. Our recommendation—we're still in the process of doing this—is to give all the Medusa employees the Southdown benefit, just freeze the Medusa benefit at either the end of this year or the end of next year, and just give them the Southdown formula for all years of service. It resulted in very, very little cost—*FAS No. 87* cost.

The 401(k) plan was certainly much easier. Because of the merger, we closed Medusa's headquarters. That closure resulted in a partial termination event, so we just decided to go ahead and change Medusa's 401(k) vesting schedule to Southdown's, which was immediate vesting. That did away with the partial termination problem. We didn't quite understand why some things were in there, but that really has to do with the evolution of benefit plans. You don't always understand how you got to a particular place. We didn't understand why they got where they were, but they allowed pretax contributions of only 2–10%, and they only matched on pretax. They did not match on the after-tax contributions. Of course, they had a match of $0.50 on the dollar of the first 6%, just like Southdown. Therefore, we didn't believe that there would be any additional cost in

putting the Medusa people into the Southdown 401(k) plan. That's what we're going to do, which has essentially no cost and is much easier to administer.

The next area is proving to be a real tough nut to crack because of the different benefit levels provided by the medical plan. Essentially, Medusa had a 90/10 plan. The company paid 90% of the cost, and the employee paid 10%, and that's in managed care. In Southdown's managed care, we paid 80%, and the employee paid 20%. Now any way you cut it, the employee who comes into the Southdown plan is going to pay more money. We wanted to be very careful in analyzing this to be sure that we had good justification in bringing the employees into the Southdown plan. Another issue in the medical plan was the contributions—the employee monthly contributions to access their medical plan. Southdown's contributions for its employees were about twice what the contribution was for the Medusa employee. You can't hide that.

We were going to go to the employees and say, "Well, we have some good news and some bad news. The good news is that you still have a job. The bad news is that you're going to be paying more for your medical care, both in your monthly contributions and your out-of-pocket costs." I guess if I had to choose between the two, I'd much prefer the job and paying the higher out-of-pocket costs. However, we had to be very clear as to what the cost impact of that would be to the company. Could we justify moving the Southdown people to the Medusa formula, the Medusa benefit structure? We went to the third-party administrator of our health plan and had it, in essence, reprocess the Southdown claims using the Medusa benefit formula. It turned out that our claim costs would have been about 25% or a third higher than what they were. I don't know about you, but I certainly wasn't going to go to senior management with a recommendation to increase our medical costs by a third. Longevity just would not allow that.

Also on the contribution side, if we were to have moved the Southdown people to the Medusa contribution level, certainly our employees would have loved it, but it would have cost the company about $600,000 a year. Again, I could not cost-justify that, so the recommendation is to move the Medusa employees to the Southdown benefit structure. The Southdown benefit structure was very competitive. Just by happenstance, we had done a study earlier in the year. We had an outside consulting firm evaluate our medical plan and make suggestions as to how to make it more competitive, cost-effective, and allow the participant more choice. We did all those things, and the recommendation that came back was not to change it. It's already achieving all the objectives that you enumerated. It is a very cost-effective plan. In terms of large manufacturing companies it is little more favorable—in fact, it may be a little less favorable—to the employee than the average, especially on contributions. Now the cement industry may be a little

different, but at least compared with large manufacturing companies they deemed it to be highly effective, and it achieved our objectives. So we felt that we had a fairly competitive plan. We recommended that we not change it—that we move all the Medusa employees into the Southdown plan.

Certainly there's going to be a communication problem there, and it's going to be bad news. People are not going to like it. But I think it's a situation where you tell the employees the bad news; you don't try to hide it. Just tell them that this is the way it is, that we think it's the best for the company, and that we think it's a highly competitive plan. They'll be mad for a week, two weeks, a month, or six months, but they'll get back to work. I think that's the approach that you have to take. Don't try to hide bad news. Be up-front with it, and then let's all get back to work.

I think the easiest decision to make was with respect to the life insurance and AD&D. Medusa limited its employees to one times base pay, with an upper limit of $50,000. The reason for that, of course, was that Medusa didn't want to incur the income tax charges on the excess insurance. Southdown had two times base pay with an upper limit of $400,000. What's the cost of providing these employees that additional coverage: two times base up to $400,000? It may not be as much as you might think. It would not be fair to project your income into our situation because a lot of these employees just do not make a lot of money. In fact, in our Florida operation—and it is a competitive wage—these truck drivers may make only $16,000–20,000 a year. That's working 60 hours a week. Usually we're the best employer that's around. Our employment in those areas is very stable, just because there are no other big employers around. We usually pay either at market or a little bit above market. We analyzed on a pro forma basis what the coverage would be for these Medusa employees if we gave them the Southdown coverage, applied the then-existing insurance premium rates to that, and came up with the cost. It was only about $100,000, and when you're talking about a company that has about $1 billion in revenue, it's just not that much money. So that was our recommendation.

That really covers the broad functional areas of the benefit plans. You can see that throughout all this, an important consideration is the cost. I don't care how altruistic some may say that companies are in providing benefits—It's still a bottom-line number. How do benefits gain an advantage for the company? How does compensation gain an advantage for the company? So that's what we do.

From the Floor: How big was the Southdown group in comparison with the Medusa group to begin with?

Mr. Cohn: The Southdown group had about 2,400 employees, and the Medusa group had about 1,200—about half our size. So combined, we have about 3,600 now.

From the Floor: It appears as though the primary consideration was financial from the standpoint of *FAS No. 87* and the profitability of the company after the merger versus before. I think I followed every example you gave. Basically, all of the Medusa people were absorbed into the Southdown benefit structure.

Mr. Cohn: It's still an ongoing process, but they will be, yes.

From the Floor: It seems with a pension formula they may have gotten higher benefits. That's a little nebulous. The main area of consideration was the medical insurance.

Mr. Cohn: That is the hardest thing to change, yes. It has a much more emotional content than pensions. Pensions are way off in the future. Medical is immediate.

From the Floor: Right. What's the geographic situation of these people? Are you all over the country, or are the Medusa people in one particular area as compared with the Southdown people?

Mr. Cohn: Medusa people are primarily in Ohio, Kentucky, Michigan, and Pennsylvania. With Southdown, we have plants in California and huge operations in Florida, Tennessee, and Kentucky.

From the Floor: Is your managed care company represented in all of these geographic locations?

Mr. Cohn: It is represented in most of the areas. Now some of our plants are in very remote locations, for example, Odessa, Texas.

From the Floor: Could you get the employees—in particular, the Medusa employees—close to doctors? I would think that would be the primary consideration. Can they get to the doctors in your managed care organization?

Mr. Cohn: It just so happened that their third-party administrator was Aetna, and our third-party administrator is Aetna.

From the Floor: OK, that solves it.

Mr. Cohn: In most areas it does. Now in some areas Aetna does not have any networks. In fact, some areas have no networks at all. We just have to use what's available.

From the Floor: You say benefits give the competitive advantage. If I were to draw a moral from this, I would say I think it shows the inertia that's involved to a certain extent. In other words, if Southdown didn't have the benefits program in place already, and if it wasn't at least roughly equivalent (if not better, in most instances), you would have had a real problem. The fact is you didn't have a real problem because they were roughly comparable.

Mr. Cohn: It indeed is fortunate that they were. But there's a certain evolution to benefits, and I can't explain why benefits in broad, functional categories are where they are. Benefits are developed over decades. I do think that one can ascertain that there are these broad functional categories, and companies, for whatever reason, have made a determination to provide benefits in those areas. But why benefits are exactly as they are, I don't know. Companies are different.

Mr. Daniel H. Kalish: You didn't give us too much of a picture of union involvement in these different companies. The evolution of benefits, it seems to me, usually follows union patterns.

Mr. Cohn: I think it certainly did when you're talking about the late 1940s, when unions started to request benefits, and that's probably how the provision of benefits got its start. We did not address the union plans with Medusa because it had just concluded in one case a five-year contract and in another case a six-year contract, and some other contracts were coming up for renewal in the next couple years. We determined not to change those at all, not even to deal with those for the present time. With the Southdown union we had a concerted effort to really make all the Southdown benefits conform into one structure, and we have that now. The union plans have exactly the same benefit plan as the salaried group, and for the most part in our union contracts we have that whatever change is made in the salaried benefit structure, they will get also.

Mr. Kalish: Were the union benefits basically better than the management benefits? Which did you have to bring up?

Mr. Cohn: In the Southdown?

Mr. Kalish: In both, say.

Mr. Cohn: We haven't brought them up in Medusa. Medusa benefits, at least the medical, are exactly the same as the salaried. It so happened that the union 401(k) plan did not provide for a match. It had a 401(k) plan, but there's no match. Consequently, there's very little participation. In the last go-round of their collective bargaining they negotiated a match, but presently, their 401(k) plan is not as generous as Southdown's, which is the union plan. The Southdown union's plan is exactly the same. There's no difference.

It would be our objective, of course, in time to get the Medusa unions on exactly the same plan as the Southdown benefits because of this desire to seek a competitive advantage and because of the vast differences in our operations. Ready-mix concrete operations are not the same as cement manufacturing, and that's not the same as aggregate operations. They're distinctly different. Now the competition is different. In fact, we probably will embark upon a study in 1999, for implementation sometime in 2000, to really study compensation, including benefits, to determine how it addresses competition in each of our markets. Also, we may, in fact, have a flex plan, but it may be priced differently in each market—certainly, for example, our Florida market. Why would truck drivers care about two times base pay for life insurance? If they can just get enough money to get a mobile home, they really achieve something. Working 60 hours a week, how do you have time to take care of personal business? It may be that vacation is a little more important to them than, say, a 401(k) match or something. So our thought is that in time, we will in essence differentiate and stratify our compensation and benefit programs to the market.

Mr. Eric P. Lofgren: We are going to talk from a general perspective, from the specific to the general, about the types of things that corporations might take into account when they're looking at pension plan design. The broad categories we're going to look at are cost, competitiveness, alignment, and culture change (whether the company's going through change or not), as well as demographics and attraction and retention.

What do companies really know about the right level of cost? I'm sure a lot of you have done objective setting with companies as to what they are willing to spend. Oftentimes, you really are putting people in the position of making an arbitrary judgment on the spot because they don't know what they want to spend. They don't know if going to adequacy would be cheaper, or if they can't really afford to pay for full benefits. What it comes down to on level of cost is the initial impetus that people will come in at, and you often have to help them look deeper. They probably don't want to spend more than they're spending now and they probably don't want to spend more than their competitors are spending. Looking for those

benchmarks is almost a matter of security. You can see that if you look at health costs.

Health costs have gone up by a factor of 10 over the past 15–20 years, and employers have ridden the wave. If they really did strongly feel 20 years ago that 0.5% was the right cost for health costs, they wouldn't be spending what they are now. However, being in sync with the market is what cost level often is, which means that it's an industry-specific deal; that cost will tend to be industry specific as to what's an appropriate level and what isn't. Look at the evolution of benefits in industries that have had fat margins, say, pharmaceuticals. It's clear that in contrast to some of the businesses with much slimmer margins that really had to watch every penny, an industry such as pharmaceuticals, up until a couple years ago, in deciding on benefits really almost had to go through a process of asking, "What can we spend money on?" This is actually how I remember plan design going about 15–20 years ago. So look at the industry for cost as a benchmark. Look at what you're spending now for cost. But also look deeper as to what the right costs should be for the benefits. Look to adequacy.

Volatility cost, depending on the employer, can matter a lot or matter a little. I'm sure many of you have seen that foreign-owned companies don't quite understand *FAS No. 87* pension expense here in the U.S. or why costs should vary as much as they do. They look for a budget to be set the following July to be hit for the following year. Some of the most inventive actuarial work will probably happen this next January and February if asset values stay down, trying to hit the expense numbers that were quoted to German parents and Swiss parents in the prior July, which was right before the stock market fell from its peak.

As for the pattern of cost, you want to look at whether the cost level has implicit in it an increasing pattern or a decreasing pattern, particularly with grandfathers and, of course, one time events, curtailment, accounting, and so forth. Lest people think that this isn't a core issue, cash-balance plans would probably hardly exist at all if it weren't for cost. After all, the impetus for so many employers on cash balance is the desire to have a defined-contribution (DC) plan and being stuck with a starting place of a DB. Now there may be some employers that, presented with a clean slate, would still go cash balance because it can be funded effectively and more efficiently, but I have to think that most employers with a cash balance, if they were starting from a slate of no plan at all, would in fact put in the DC plan they're mimicking. It's the cost of termination of the DB plan that has given birth to the second most popular design today. So cost can have quite an impact.

If you talk to employers as to what's important, *competitiveness* will be one of the first two or three words out of their mouths, and it's truly there that they're looking.

Their board and their senior management are looking at their benchmark companies over and over, but in retirement plans the truth of the matter is that in terms of making a difference to the employees in the bottom line, other than the cost element, competitiveness often isn't there. In fact, just take a little survey. I'm from Watson Wyatt. Without getting into plan details or anything, how many of you would regard yourselves as competitors to Watson Wyatt? How many of you know our benefit formula? OK, and you're retirement consultants. If there is anybody who is going to focus on the worthiness of the benefit retirement formula in making a choice of one competitor versus another, it would be retirement consultants, yet not one of you as an employee knew what the competitive benefit formula was. That's OK; I don't know what the Mercer or the TP benefit formula is either.

Competitiveness sounds like it's important, but it really should be a frame of reference rather than a decision-making deal; otherwise, you're fooling yourself because it isn't a decision-making tool for your employees in terms of the industry. Sometimes there will be situations where there are two employers in town, particularly if you have a small town. I used to work for a firm that had a plant in Osceola, Arkansas. There were two employers in Osceola, Arkansas. It was basically an hourly workforce, and the comparative benefits there did mean something as employees looked at it. Of course, in that case it was the difference between dirt and dry dirt, but it did make the difference. And it will vary by industry.

As for alignment with culture, I don't know about down in Texas, but I have to tell you that as consultants in New York, we sit around and talk about alignment and culture with human resources (HR) buddies, and they talk about alignment and culture with us, and this is a really big deal up here.

Mr. Cohn: We do that all the time too.

Mr. Lofgren: It's really important to have plans that actually reinforce business objectives. If you have a paternalistic company, you probably want a plan that sort of says, "Hey, come on in, stay here forever." If you don't have a paternalistic company—if you're a bank where even the senior executives don't have the vaguest idea whether they'll have a job there six months from now or not—you probably have a culture of, "If you have a job today, you're lucky." If that's so, you probably don't want a benefit program that says, "If you stay here for your whole career, you will get such and such." It would be such a misalignment that all it would do would be to breed cynicism, and the last thing a bank in that situation needs is even more cynicism. So you want alignment with business objectives, HR objectives, total compensation, total benefits, and total retirement.

Let's talk about some elements of alignment. A company cannot align its people and its business strategy if it has the wrong people. Retirement plans—and I'm using the term broadly to include retiree life and retiree medical—retirement event programs, if you will, do affect to some extent who you have and how long you have them. I don't know about attracting so much, but these programs sure have a lot of effect in certain circumstances on retaining, and you can't align your people and your business strategy if you have the wrong people. Just envision a company that's going to a new philosophy. It's going towards one of those strategies where it doesn't promise employment anymore, and it's not year to year, but it promises employability—one of those new partnerships, and under those new partnerships the employer will provide training. The employee's job is to keep his or her skills honed by taking advantage of this training. As long as there's a sync between the employee skills and the employer's needs, the relationship might be 5 years or 30 years. It varies. If it gets out of sync, the company has provided employability. The employees can go somewhere else. There are a lot of companies looking at these types of concepts midway. We're a company. We need to keep our flexibility. And if we have a traditional retirement plan design, that can freeze our employees in place.

Suppose you have a traditional DB plan, building up value, which has an unreduced at 55 and 20, where you get a lot more value if you leave at 55 than if you leave at 54 (Chart 1). Also suppose that there's a typical traditional DB plan accrual curve, and on top we're adding the retiree medical, which is nonvested until age 54.9 and then is worth a lot at age 55. If you leave at 55, you get 10 years worth of benefits with no Medicare offset. It's not worth quite as much at 65, because there is a Medicare offset, and there are 10 years less benefits, and they're 10 years further out. So this is a present value to benefit at any point in time divided by pay at each age, and it shows the accrual pattern under a traditional setup. Now if you're 53 and you're not given a window, you have an accumulated value of about 50–60% of pay that'll climb to maybe 450% of pay in this extreme example, in two years by age 55. First, you'd have to be a fool to leave and give up that value, and, second, it's setting a price for an early retirement window.

If you're an employer, you have these types of plans, and if you want to downsize or right-size a particular group, you want them gone. You've put a very strong concept in their minds of what they're after and what it would take to get them gone. So you make all your windows very expensive if you have this type of setup. Let's go back to the companies with the so-called high-performance cultures that they're putting in. It would seem that half the companies nowadays promise employability. Well, if you're trying to change your culture to where an employee really has to be a charger on the high-performance level year after year after year, and there has to be a match or else the employee is gone—which is sort of like the

idea of proposition from the employer's perspective—your employees had better really need jobs for this to work. If there becomes a seller's market on employees, I don't know how much this proposition works. Anyway, if you have that situation, who will to be the barriers to change? You want to change your organization.

The barriers to change are most likely to be the people who have been around a while. If they've only been around a year or two, change is no big deal, and they will be around a lot longer. Somebody who's been around 40 years and is about to leave is not a barrier to change. This employee decides, "Oh, I'm glad I got it in under the old way." Your barriers to change are going to be your people with 15 years of experience and another 15 years to go, which is precisely the group that you're freezing in place. Now when you have plans like this, if you look at the turnover patterns by age, there's just no turnover to speak of in this group. I worked with a Fortune 25 company that had less than a five-person turnover per year in that age range in that situation, out of about a 15,000-person group with the plan. That's a problem both for setting a price for any windows and for locking people in place. Not wanting to lock people in place is part of the reason why pension-equity and cash-balance plans have been so popular. These types of designs are giving more value early, and, after all, most of the people in the workforce still are under age 50, so most of the people are seeing an immediate increase in value, and it's going to be popular. You're about the same at 65.

You have a story about protecting retirement. The decrease in the early-retirement benefit is the fuel that pays for this. So the story you have is three-pronged. One is that employees will like it by and large. Anybody who is right up here, you can grandfather them. Your employees will like it. It'll save money overall, so your financial people will tend to like it too. That is an engine that will make the whole thing less costly, by eliminating the window. You also have a new target for early-retirement windows. If somebody leaves at 53 and is looking two or three years ahead, that's an increase of 25% or 20% of pay—a lot different from 200% of pay, the cost on benefits for the window. So you're setting up a pattern that works. Fourth, if the situation in the future is different from what it is today, to where you actually want to keep your older people and not have them all disappearing, you can preserve the option for people to leave at a later age—at an early retirement age—by putting in an ad hoc window if you wish. If you don't, why guess 10, 15, or 20 years in advance that you're going to want this type of benefit and prefund it at cost for shareholders rather than future shareholders for it? There are a lot of winners in this type of design change, which is part of the reason why they're so popular. They have the added virtue that if you don't grandfather the people in this range, you won't be freezing into place your opponents to change.

In looking around we find this is the type of plan design a lot of employers like. This is a consideration employers take in plan design. It's really a matter of what you as an employer think is fair. If you're looking year to year and you really look at benefits as current compensation, the DC approach is the only approach that's fair. You give the same 4% to everybody. A DB plan, a traditional plan, doesn't do that. It gives something worth 0.25% to a young person and worth 8% to an older person. If people do stay with you until retirement and you want retirement adequacy, then you might have a concept of deferred compensation there; that benefits are deferred compensation. You're going to be measured by what people get when they leave you in comparison to what they get when they leave somebody else. There's a matter of what your time frame is and your philosophical view on what a benefit is. Then there are designs that you can do either through pension equity or by having both a DB and a DC plan married together, which will give you a dual horizon. The game there would be to have benefits that work as lump sums for people who have a current compensation framework, which will be younger people, and to deliver benefits of deferred compensation for career employees or older employees.

Going back to a high-performance culture, baby boomers are half the workforce—75 million out of a workforce of 150 million—and they're in a 17- to 18-year span of age. They're becoming older now. The oldest baby boomers, as you know, are age 51. The youngest are age 34. In fact, the baby boomers have had the same level of mobility as their parents and grandparents when you look at people at the same age. So yes, the workforce as a whole is more mobile, because the average age of the workforce fell by six years, but if you look at baby boomers at age 30, they acted just like their parents or grandparents at age 30 in terms of how long they stayed on the job. It's surprising, but it's true. At age 40 they acted like their parents and grandparents in how long they stayed on the job at age 40. There has been some change above age 45, but that's the Eisenhower generation. That's not the boomers. So far the boomers have been staying on the job longer, actually, than their parents and their grandparents.

It's reasonable to assume, or at least to postulate, that the baby boomers will want to settle in when they're 55, just like every other generation that has ever gone before them. If so, you're going to have a less mobile workforce as the baby boomers age, and that's going to be a real clash for these companies—which seem to be half the companies nowadays—that are going to a high-performance culture at the same time as the baby boomers are getting older. There's a conflict among baby boomers for the first time, saying, "OK, we didn't save a cent. We went, we had a good time, we were a very materialistic group. Now we're 50. We care about retirement income." If the baby boomers as a group do that—and if they want to retire early, they will do that—they're suddenly going to want a return to paternalism as, say,

half of them are age 50+, the oldest is 51. So you can say in about eight years, if that's right (and it might be right), that you'll have a new paternalism in society, at least among the half of the workforce that's age 40+ at that time. So there's going to be a need to think about how to accommodate the baby boomers. They have a lot of votes.

Retirement plans, as we've been saying, do reflect the deal. If you're one of two companies in town, and people tend to stay with you whole career, and you don't want them working when they're 80—you figure you can only haul concrete until you're 60 or so—then you probably want a retirement plan, and you probably want one that emphasizes the message, "Stick with us and then retire in comfort." One of the better conceptual frameworks that I have seen for the cash-balance approach or a DC approach was the resources and rewards conceptual framework that was put out by Owens Corning about four years ago. It was great. It was philosophically weighty: Each year we'll get our resources together, and then we'll give you a reward according to how we did. It's a year-to-year sharing.

What's interesting to me is to look at the background of the benefits professional—not the actuary or the consultant, but the person who was in charge, who was part of that. He had a very clear conception of what he wanted. The consultants who worked with him, I thought, did a great job in bringing it to fruition. However, he had a pretty good conception at the start of the process, and this is a guy who started out at Eastern Airlines, which went bankrupt. There was not much job security there, so he moved to Southeast Bank, which got bought out by some other bank. The banking industry's had a lot of mergers and acquisitions, so he moved from there to Society Bank in Cleveland, which merged with Key Bank out of New York. He was out of a job there, so he moved on to Owens Corning, which was on the verge of bankruptcy over asbestos problems or something. Now a person with that background should have no reason to believe that employment is anything but a temporary concept in America, and that was what he thought. That's what he believed was appropriate to a company fighting off bankruptcy. And they put in a one-year-at-a-time resources and rewards program. That fits the concept of what the deal is between the employee and the employer.

However, if you were the only factory in Osceola, Arkansas, it might not have been such a good fit. And then you have this partnership concept, where you might want to tie into year-to-year cash income for the short term or to really tie into benefit adequacy, which means benefit adequacy is replacing the pay you had before retirement. I personally fail to see how that can possibly be done unless the benefit formula ties into final pay or final average pay. If you have a concept where you want a partnership—that is, if somebody does stay long and accrues retirement income—then you're pushed towards the final average pay approach in my eyes.

Let's look at change really quickly. A significant change in benefits design signals a change in the employer-employee contract. As the Medusa employees come in, the benefits will be about the same—there are some wins, there are some losses, but it's the same basic approach when you come right down to it. There will be some comfort in that. If they'd gone off and put in purely DC or cash balance with a savings account from which they were going to pay medical benefits that might be enough or might not be enough and have a bonus if there was extra money at the end of the year, employees would have thought something was up, and they would have been right. It would have meant a big change in the employer-employee contract. So there's an intricate link here, and as companies do go through this process of change, the retirement plan is so key that they have to think about whether they want to lead with the retirement plan or build up to it. Also, retirement redesign does affect the workforce structure, which affects the direction of change. As for the pace of change, you get a very strong message about the pace of change when you change the retirement plan. One company that I was working with had three entirely different designs. People working side by side, depending on whether they came in through acquisition 1 or acquisition 2, had entirely different plans. Half of them had retiree medical. A person the same age who had the same service and salary, but who came in through a different route, would have no retiree medical.

One of the three plans actually had six formulas, and there are three groups. One group had three of the six formulas. Another group had five of the six formulas. The third group had a different five of the six formulas. It was very possible for a single person, depending on whether he or she retired at 55, 60, or 65, to have different formulas apply to his or her given personal situation. It was impossible for anybody to follow. They wanted to simplify, and they wanted to change. As you can imagine, though, in a workforce of, say, 5,000 people with 10 different formulas running around, it's pretty hard, without spending an awful lot, to get a formula that doesn't hurt anybody. We don't want to hurt people. How do we do this? And they were strongly considering putting in a ten-year grandfather, and this is a company going through a high-performance culture. So we said to them, "OK, we think we understand you. What you're telling us is you really want fundamental change in your company starting in the year 2008." That wasn't what they wanted. They wanted fundamental change starting now. We pointed out that, furthermore, the people they were thinking of going deeper into grandfathering were precisely the opponents to change who, should they exist in their workforce, would certainly be in that age and service bracket. Then we ended up on the other end, trying to keep them from being too draconian.

On the timing of change, as I said, you don't want to do a major plan redesign that has a major cultural message and change nothing else in what you're doing.

Otherwise, it's going to be jarring, an "Are we fish or are we fowl?" type of question to the employees. Is your company ready for change now? Is it committed to change? Should you lead with retirement, sending a clear signal, or build up to it?

Chart 2 shows the shape of the workforce in 1980. The oldest baby boomer was about age 34, and the chart shows the baby boom compared with the generations above it. A more traditional shape prior to the baby boom by percentage would have been something like that. This is a very young workforce. We responded to that with the advent of 401(k) plans and cash-balance plans, and that was appropriate. Chart 3 shows the workforce in 1996. This is the workforce of America. This is not of any particular company; this is the American workforce. You can see it's pretty much the same shape, except under 25. Now who among us has had clients or in our own company has been having trouble hiring under age 25? And who among us thought it was the economy? The economy certainly has something to do with it, but there's something else. There's a shortage of supply and the shortage is going to continue for a while at those age brackets.

Companies have to figure out, when they're looking at retirement design, not simply the shape of the workforce they'd like but also the shape of the workforce that's available and whether the workforce ten years from now is going to look anything like the workforce now. This is a fundamental issue. If you like the workforce you have now, think you can maintain it, and you're looking at retirement design, you really ought to do focus groups and ask the employees what they think about it. But if you'd like a workforce that looks and acts differently, or you think because of demographics you have to get a workforce that's different, it doesn't make much sense to ask your current group of employees what they want. All that'll do is tend to give you a plan that reinforces having a group of employees like those you currently have, and if that's not where you're going, it's the wrong thing to do. Now you still might do focus groups, not for helping design but rather for getting clues on how to sell it to them. I'm completely serious there. If the workforce you want is not the workforce you have, your retirement design should fit the workforce in the future, and you shouldn't pander to the group you have. You want to force change upon that group, and if you're leading using the plan design as a business intervention to help promote change, naturally it will promote some discomfort.

Chart 4 shows the shape of the workforce in 2006. This is completely decided by now. You might say, "What about immigration? We just had this big high-tech immigration bill." It's a 150-million workforce, and they increased high-tech immigration by 50,000. It's not going to do anything. In order to change this shape to a shape not like the shape in 1980 but just to a normal shape—a slight slant down—we'd have to move 50 million of the 150 million around, pushing 25 million out and bringing 25 million in. We aren't going to do that to a third of our

workforce just to have the shape by age pretty. So if you look at the shape of the workforce in 2006, and you accept what we've been saying for a while out of my group—that mobility is tied to age—you have to wonder whether you're going to have a mobile workforce ten years from now or a young workforce ten years from now. The average age of the workforce in 2005 is going to be 40, which is the same thing it was in 1962, whereas in 1979, say, the average age of the workforce was under 35. It's more upwardly loaded now than it was in 1972. You have to think about what that's going to mean for your HR policies. "Design for where you're going, not just for where you are today," would be the advice that employers generally take when they see this stuff.

I think what I've tried to say and show is that it's so complex that there's really hand-tailoring required. The corporate perspective really has a lot of common threads in most companies, but every single company's unique.

From the Floor: I'm curious, Mr. Lofgren, what you make of the federal charge to the enrolled actuary to act on behalf of the plan participants in the approach that you've outlined here.

Mr. Lofgren: Plan design is a settlor function. That charge has nothing to do with design, in my opinion. There are things such as in the valuation for funding to which the charge to act for participants is very applicable and very clear, but, say, the choice of terminating a plan, that's a settlor function. If we were acting solely on behalf of participants, there wouldn't have been an actuary able to get involved in any termination. There have been tens of thousands in the last decade.

From the Floor: What if you cut back benefits with a new program?

Mr. Lofgren: Cutting back a benefit is hard to do if you're acting on behalf of participants. If you had it like that, it would be hard for any employer to ever start a new program knowing it could never, no matter what the circumstances, take a step the other way. So there's probably a reason why there's that legal distinction. But there are certain things that are fiduciary duties, and there are certain things that the company does as the company rather than as the plan sponsor. You sort of need that flexibility, or else every plan would have 100 different benefit options. You'd never be consolidating.

Mr. Torrie: Part of the original designs for having retirement plans was a nice way to get rid of employees once they were nonproductive or not as productive perhaps as a replacement employee. That would certainly affect the bottom line, but I didn't hear any discussion of that when you were deciding what kind of pension plan to have.

Mr. Cohn: Actually, we have had this discussion with senior management as to exactly what they want to do with the workforce. We've gone through reengineering the past few years in which we've reduced the number of people actually running our plants, and when you do that what you eliminate is anybody to serve as backup. If you have somebody operating the control room—and most of these plants are run by computer—but you don't have anyone else to do that because of the downsizing, then what are you trying to do with that particular employee? Do you want to induce that employee to leave early, or do you want to structure your compensation and benefit programs to induce that employee to stay until you decide to let him or her go? Obviously the answer is that you want to structure compensation and benefits to keep the employee around until the company decides it wants to get rid of him or her, but I'm not sure that we've really focused on that. I'm not sure that we've really structured our plans to accommodate that; that really our plans or our compensation program harmonizes with this workforce strategy of retaining employees as long as possible because of the downsizing that we've gone through. Some of these positions are highly skilled. The pool that we draw from, because we're in remote locations, is somewhat limited. In fact, in our smaller towns we hire employees from other cement plants, and then when they want to hire they hire from us. There's just not a big pool to draw from. So I think it's certainly relevant that we address the issue of whether our retirement plans serve to retain employees or induce them to retire early.

We have gone through an early-retirement window. One of our cement plants was a split-plant operation, and if you know anything about the cement industry, you know it takes more people to run a split-plant operation. We have these big rotary kilns in which we, in essence, burn limestone to produce plinker, which is used to produce cement. We had that in one location, and we had what's called the *finish mills,* where it's actually ground up into the cement at another location. We combined those two locations. You don't need as many people to run a cement plant in that situation. But these are union people, so how do you reduce your workforce without causing a lot of union problems? We go through an early-retirement window. What number do you use to induce them to take the early-retirement window? We knew it had to be an impact number. We couldn't just say that we would increase their years of service by five and all their pay by five years, or what have you. We knew we couldn't do that. It had to be a number that had a dramatic impact on the target group to induce them to take it because if they didn't we were going to have to lay off a sizable number of people in the workforce.

That's an issue that we had to go through. We were very, very generous, and we got the number of employees that we wanted to leave. It was structured such that we didn't get more than what we needed. The industry itself is really very small, so the culture is very similar among different companies in the industry. Senior

management really constitutes the culture of the company, so in their decision-making process they're intuitively considering culture as part of that. I would agree that the issue of benefits by itself probably is not a large determinant of whether one will work for Southdown or some other company. I'd say maybe on a scale from 1 to 100, maybe 10 or 15 is probably the significance of benefits. One reason is they're very similar among all the companies. All the functional areas are covered. Specifics may differ, but all the functional areas are covered. Benefits are almost a given. In fact, I can recall only one time that a prospective employee ever made a decision solely on the basis of the benefit plans that we provided, and I had to demonstrate to him that at the end of the day, if he came to work at Southdown and stayed with Southdown, he would have more in retirement income than he would if he stayed at his previous employer. I had to make certain assumptions, for example, that he was actually going to get a bonus. But that's the only occasion that I ever recall that benefits were the determining factor.

CHART 1
FREEZING EMPLOYEES IN PLACE
TRADITIONAL RETIREMENT PLUS RETIREE MEDICAL ACCRUAL PATTERN

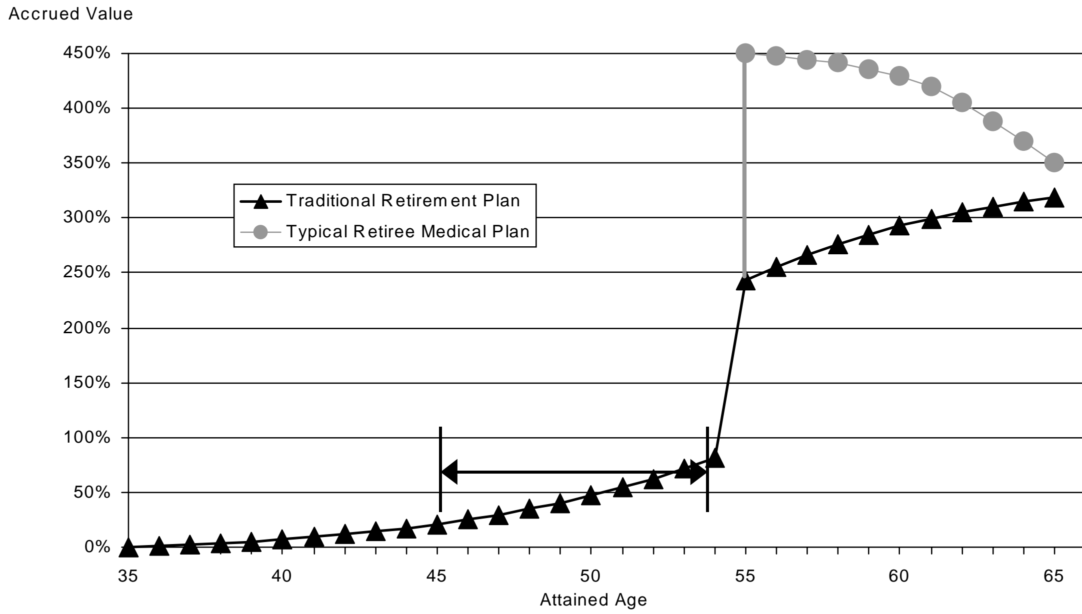
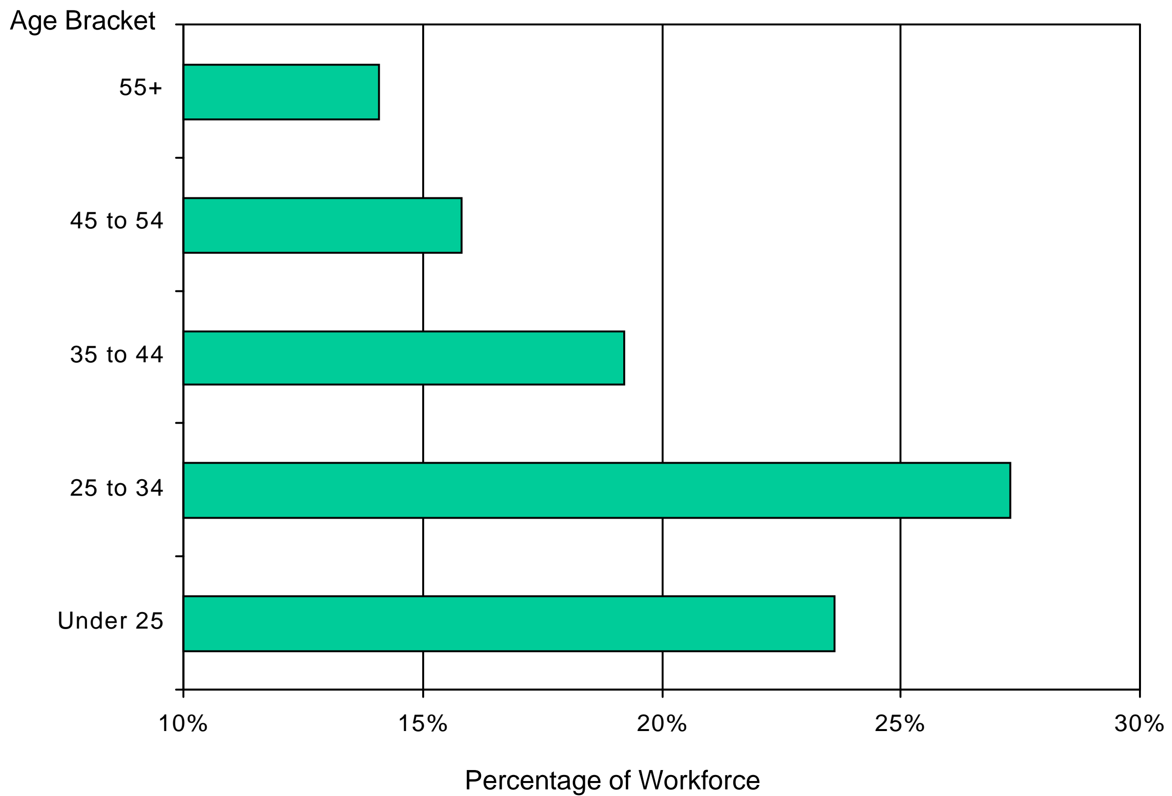


CHART 2
SHAPE OF THE WORKFORCE, 1980



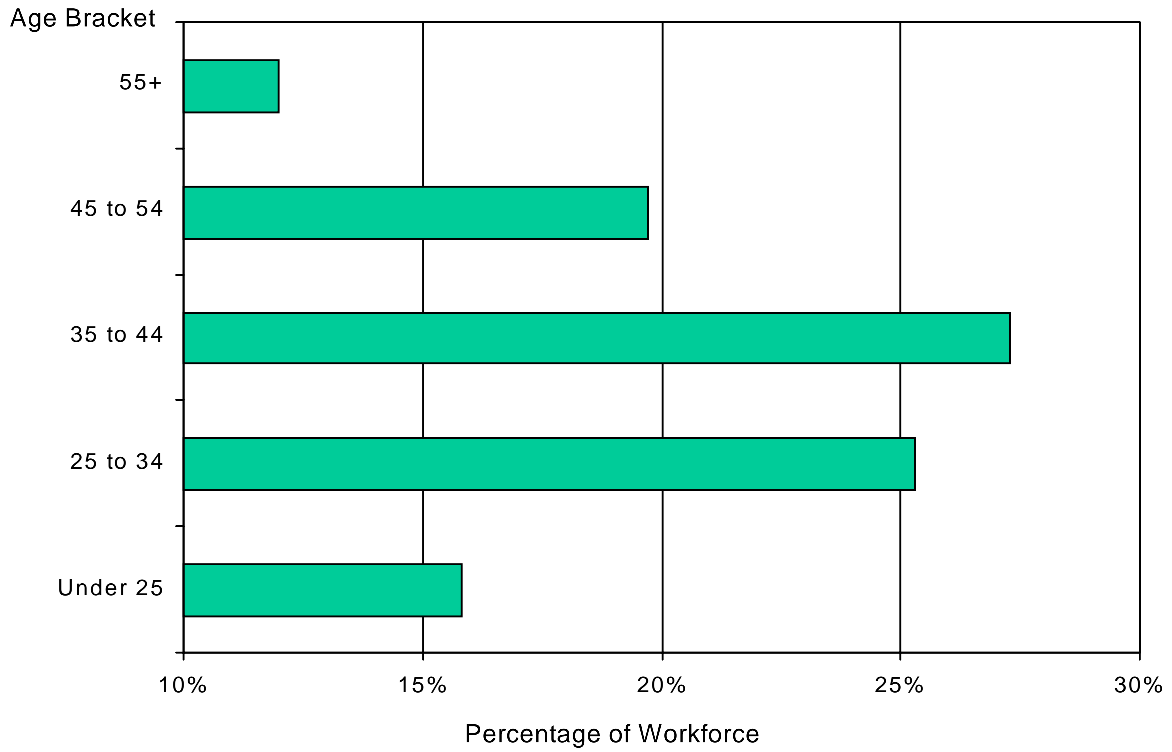


CHART 3
SHAPE OF THE WORKFORCE, 1996
Age Bracket
55+
45 to 54
35 to 44
25 to 34
Under 25
10%
15%
20%
25%
30%
Percentage of Workforce

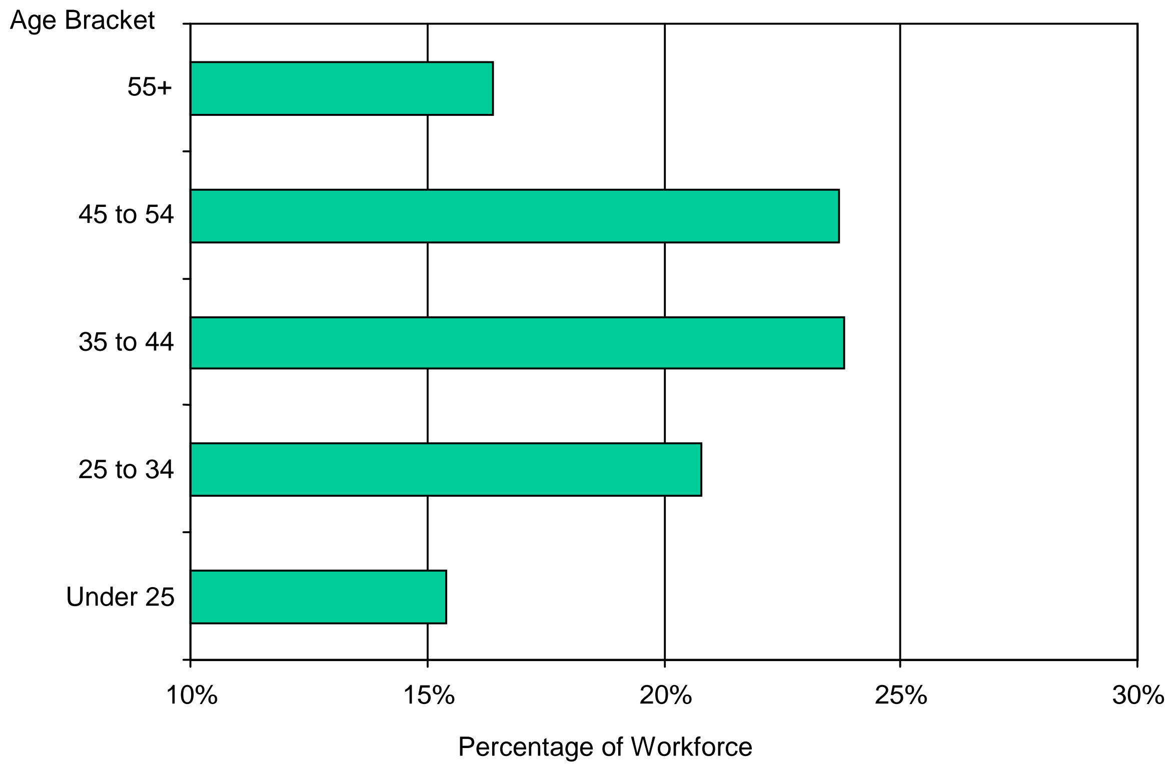


CHART 4
SHAPE OF THE WORKFORCE, 2006
Age Bracket
55+
45 to 54
35 to 44
25 to 34
Under 25
10%
15%
20%
25%
30%
Percentage of Workforce