RECORD, Volume 26, No. 3*

Chicago Annual Meeting
October 15-18, 2000

Session 56IF
Recent Trends in Retirement Benefits Design

Track: Retirement Systems

Moderator: MARY HARDIMAN ADAMS
Panelists: DAVID W. RIDDELL
PAUL RUSIN
Recorder: MARY HARDIMAN ADAMS

Summary: Panelists discuss recent changes in the design of retirement benefits programs. Topics include design trends in:
- *Public employee retirement systems*
- *Multiemployer retirement programs*
- *Executive compensation plans*
- *Effect of mergers and acquisitions on retirement systems design*

Ms. Mary Hardiman Adams: The panel is comprised of Dave Riddell and Paul Rusin. I was a consulting actuary for many years with Buck Consultants. I'm retired and I'm enjoying reaping the rewards of a marvelous defined-benefit (DB) plan. It's really great to know that the check is getting deposited every month.

Our panelists are not retired. Dave Riddell is a senior actuary and an account manager at Watson Wyatt. Dave has primary responsibilities for Watson and Wyatt's relationship with several major clients and focuses on the overall linkage among his client's business plans—their human resources (HR) strategy and their compensation and benefit programs. For each of his clients, Dave is also the senior consultant responsible for design and actuarial pricing of their retirement plans. In this capacity Dave's experience includes regular evaluation of pension and retiree medical/life programs, asset/liability modeling, plan design, discrimination testing, and merger and acquisition (M&A) work. One of Dave's specialty areas is his work with professional firms and the unique needs of these firms with respect to their retirement programs.

Dave joined Watson Wyatt in 1975 after receiving a B.S. in economics from the University of Pennsylvania and an M.B.A. from the University of Michigan. He's an FSA, a Fellow of the CCA, a Member of the AAA, and an enrolled actuary. He has served on Watson Wyatt's National Actuarial Practice Committee and is chairman of Watson Wyatt's Actuarial Peer Review Committee.

Paul Rusin is a principal and consulting actuary in the Chicago office of Buck Consultants, Inc. He has more than 20 years of experience in all aspects of employee benefits, including:

- Technical analysis and consulting regarding the funding and expensing of pension plans and other post-retirement benefit programs,
- Retirement design and administration,
- Accounting under FAS 87, 88, 106, and 112,
- Union negotiations,
- M&As,
- Plan terminations and annuity contracts, and
- 401(k) design and record keeping.

Prior to joining Buck, Paul was an actuary with The Wyatt Company, where he was responsible for consulting with clients on all financial and HR issues related to employee benefits; that is, to employee retirement, welfare, and compensation programs. Paul graduated from Bradley University with a B.A. in mathematics and from Purdue University with an M.S. in applied mathematics. He's an FSA, a Member of the AAA, and an enrolled actuary under ERISA.

The first topic is IRS Ongoing Review of New Comparability Plans, where the use of component plan testing denies some groups of employees the opportunity to accrue higher benefits. Dave will start this off. His remarks will be followed by comments from Paul and then there will be audience participation, which is really a large part of this session.

Mr. David W. Riddell: We were fortunate enough to have the IRS release some proposed regulations on new comparability in the last week or so, but we decided to start out this session with a focus on the discrimination testing environment for retirement plans. This serves as the underpinning for almost all of the modern plan designs. A number of you, at the outset of Tax Reform Act (TRA) 86, probably saw the law and said, "The old rules under 81-202 aren't available; therefore, we need to go to a safe-harbor design." But, as the rules and regulations under TRA 86 came out and really took hold, a number of people saw that you could develop very attractive and innovative retirement plan designs using the general testing opportunities under the TRA 86 regulations.

That's really what gave the impetus to age-weighted DC design, service-weighted designs, cash-balance plans, and other variations of accrual patterns that didn't fit into a safe harbor. These new designs were very attractive to employers, especially if the employers went from benefits that were simply a "protection benefit" (like a traditional DB plan) to a plan that was designed to focus on the attraction and retention of workers. As the creative designs came out, the IRS saw that there were some issues coming across that really weren't consistent with the TRA 86 intent. The TRA 86 intent was to get broad coverage of workers in retirement programs. However, by pushing the 401(a)(4) general test to the maximum, you can create a design under which one class of employees could get an enormously higher accrual rate than another class of employees and still be shown to be nondiscriminatory under the general testing rules.

At the beginning of this year, the IRS came out with a notice, indicating that the Service was going to review the rules and regulations that were out there for discrimination testing. It solicited comments and these came in, I believe, by May. Then, just a week or so ago, it issued a proposed regulation which introduced some changes that it hoped would make the rules work the way they were originally intended to so that there would be a broad benefit available to everybody in the workforce.

I would like a show of hands. How many people have worked on non-safe harbor plans? How many have actually run the 40l(a)(4) general test? Now, tell me how many of you actually have had other people run it for you? Most of us go through the mathematics once and learn, fairly quickly, what some of the key concepts are, and by and large the biggest concept is that the lower-paid employees are younger and the higher-paid employees are older. By testing a combined DB and defined-contribution (DC) program on a benefits basis, you get an attractive result. The IRS recognized that this is consistent with having only a DB plan, under which the younger employees get a benefit of much less value than the older employees.

The IRS and the proposed regulation have pretty well preserved the opportunities to do the general testing as previously structured, but it has added a couple of provisos. One is that the employees generally have to have a minimum contribution rate in order to support what's going on for the higher-paid employees. If a plan can stand on its own from a coverage testing standpoint, the plan is tested under the same rules as it has been using under the existing TRA 86 regulations. For a DC plan, if everybody within the eligible group can grow into the highest contribution rate under the program (either by growing older or by gaining more years of service), the old rules stay in effect. You really don't have any new hurdles. But under some of the designs that have been available, you could have had a situation in which 1 group of employees gets a 5% contribution under a DC plan and another group gets 15%. That design didn't fit into a safe harbor, and it required somebody to change status to get the higher contribution rate.

Another design could be a pay-related benefit under which the contribution for pay up to $50,000 was 5%, but for pay over $50,000 the contribution was 15%. To get the higher contribution rate, you had to grow into it by an increase in pay level. The IRS said, "That's really not fair, because some of the job classifications may not have the opportunity to grow into the higher contribution rate, especially when the higher contribution rates are linked to pay levels of $100,000 or more." The IRS said that that type of plan must have some sort of gateway contribution percentage, which insures that everybody will get at least a minimum contribution, or that there will be a relationship that can't be exceeded between what the lowest contribution rate is and what the highest contribution rate is.

Now, how many of you have plans that don't fall into the group that will be under the old rules? In other words, you have a plan that maybe bases the contribution on a differential salary. You have one? Can you talk about it?

Mr. William S. Wright: I have a plan at an accounting firm with separate contributions for partners versus employees.

Mr. Riddell: If we go back to the pre-TRA 86 period where we were using the 81-202 comparability rules, most of that work was with respect to fairly small employers and some of the professional services firms. However, the new rules have a much broader applicability, since they underlie the discrimination testing for broad programs that apply to huge workforces. These programs generally have been designed for fairness and equity, so most of these designs (as the IRS looked at them) were not abusive; they simply were a design that fit what the employer wanted, in terms of attracting and retaining employees.

Mr. Paul Rusin: The only thing I would add is that I have personally been involved in designing and implementing a couple of age-weighted profit-sharing plans. When this issue first came up, I was very much concerned as to whether or not there was going to be any impact on those types of plans with these new regulations. In general, they are not affected. The age-weighted profit-sharing plans can continue to be cross-tested and to meet the original nondiscrimination regulations.

In Bill's example, the professionals are entitled to one higher allocation rate and the staff is at a lower rate. By cross-testing under the general test, the plan complies with 401(a)(4). The difference with most age-weighted, profit-sharing plan is that the allocation rates are all broadly available. In theory, everyone in an age-weighted plan has the ability to age and grow into the higher rates that the older people are currently enjoying. Whereas, in Bill's case, the staff is constrained to the current level and has no opportunity to ever achieve the higher allocation rates that the professionals of the company have available to them. There is one other point made in the regulations to help make sure that there is no abuse even in a plain vanilla, age-weighted situation. The regulations require that allocation rates increase in a smooth pattern and not have plateaus and jumps. There is, in fact, a second look that has to be taken at age-weighted, profit-sharing plans but, in general, they are going to meet the new proposed requirements.

Mr. Riddell: The effective date on the proposed requirements is scheduled to be January 1, 2002 or presumably the plan year beginning in 2002. The existing rules are scheduled to stay in effect for the rest of this year and all of next year. I'm sure that there will be some minor changes in the regulations. (When we had the TRA 86 regulations, they actually got finalized, withdrawn, and reproposed.) This will probably be an ongoing process as we help organizations design programs and come up with creative ideas. The IRS will keep looking at these ideas to make sure that they are consistent with the original intent of TRA 86, which is the broad coverage of participants in retirement programs. That's the underpinning of what I find in design work: as an employer expresses a need for a program or for a delivery of benefits to a specific group of employees, it's generally working outside of the safe-harbor category. That is where these rules operate and make possible some of the designs that really help employers meet their needs in terms of attracting and retaining employees. Paul will talk a little bit now about another trend that has become popular, which is the choice between one program and another program on a onetime or permanent basis.

Ms. Adams: Now for the second topic, which Dave just alluded to, which is Employee Choice. There is a long list of topics here, and Paul's going to lead off on this one.

Mr. Rusin: I think employee choice is probably the one trend that is truly identifiable and something that is becoming more and more commonplace in the retirement design arena. I'd like to spend a little bit of time with that. If you go back and look at history, employee choice probably started off in the health and welfare area with cafeteria plans and flexible-benefit plans. I think that the overall trend toward DC plans, including 401(k) elections and employee investment elections, are all a part of this trend toward employee choice that has begun to spread into the DB plan area as well.

Generally, the tact taken has been that if the code or the regulations do not specifically prohibit it, then employers are going to go ahead with a program of choice if the end result is desirable from a design standpoint. It's hard to prove a negative, so there have been a lot of exotic plan designs incorporating employee choice. I'll try to touch on some of those in a moment. But there have been instances where designs incorporating employee choice have been disallowed by the Service. One example: Several years ago a firm asked for an IRS ruling on a choice between a severance benefit and a pension window benefit. The IRS determined that such an election is specifically prohibited in the Code. Under section 401(k) it was not a true choice between cash or deferral. It was a choice between cash on the severance side versus a pension benefit on the pension window side. There have been some adverse rulings, some things that haven't been permitted, and some designs yet to be ruled on.

There are a number of options available to the employee. One is a onetime election to change to a new formula: for example, traditional DB to a cash-balance plan or a pension-equity plan (PEP). Many employers are using these elections when moving to hybrid pension plans such as cash-balance plans and PEPs. Those plans are different in terms of benefit delivery versus a traditional DB plan, and so, with a change of plan, some people are either advantaged or disadvantaged by that change. One of the ways to get around that criticism by those hurt by the change is to give the employees involved a choice between electing the traditional program or the new program. That's very basic and a very fundamental feature in many of the transition programs that are set up when a move to a hybrid plan is made.

What goes a little bit beyond that is some employers have taken employee election a step further and have permitted their employees to choose on an annual basis which retirement program to participate in. Very often, it is a choice between a DC and a DB plan. Again, there's nothing specific in the Code that prohibits that kind of annual election. Ultimately, with that kind of an arrangement, what you end up with is going back to the underpinnings of the whole regulatory environment that Dave mentioned a while ago and that's the discrimination regulations. If there is a choice between two distinct types of retirement programs for your employees, especially on an annual basis, there's probably going to be some sort of plan aggregation coupled with annual testing under the 401(a)(4) General Test to show that the benefits that have been elected by the employees are being distributed fairly and there is not a discrimination issue.

Ms. Marie B. Larsen: How does that operate in a 401(k)/DB environment? Can you still elect to defer your pay in a DC plan but accrue benefits in the DB plan? Or, if you elect to defer in the DC plan, are you out of the DB plan altogether?

Mr. Rusin: More often I've seen the latter approach where it's strictly one or the other, but there's nothing to prevent the approach whereby you're always eligible to defer monies into the 401(k) plan, and it's really a choice between the match or DB participation for the year. Discrimination testing then requires a look at what the actual elections are, what the actual benefits being delivered are for all participants, and what the benefit accrual rates during the year are for your population. To the extent that elections change materially from year to year, you have a change in your plan population that is going to require testing on an annual basis rather than relying on the triennial cycle.

Mr. Jack Forstadt: The testing that you would do is based upon the actual choice the people make. It seems to me that in doing that testing, the choice is translated into a retirement benefit at an assumed retirement age. Some people may make a choice that is a "bad choice" assuming that they stay until retirement but a "good choice" based upon their own personal goals and plans. If I think I'm going to leave employment in 3 years, even though I may be 55, I may want the 401(k). You wouldn't test the best choice but the actual choice.

Mr. Rusin: Right, the participants chose the benefit that they think is the most attractive or that is more attractive to them. The cost of those choices and the discrimination testing is done afterwards. If the choice is between a DB plan and a DC plan, especially if the DB plan is a final average pay plan, an older employee may see the advantage to choosing the DB plan. An employee who thinks he or she can invest wisely and get a high rate of return may choose the DC plan, even though under most reasonable sets of assumptions it can be demonstrated that the DB accrual would be more valuable.

Mr. Forstadt: When you do testing based on the actual choices the employees made, you apply a reasonable set of assumptions that may or may not confirm that the employee chose the most valuable benefit.

Mr. Rusin: Right. On the DB side, we are testing the choice made to accrue under the DB plan and we look at the normal and the most valuable accrual rates. The DC plan benefits can be cross-tested and the plans aggregated if need be.

Mr. Forstadt: Dave, I haven't had a personal experience with this type of an arrangement, but the understanding I've had in talking with some of my comrades is that any testing is based on actual choice. Do you feel differently, or have you had different experiences?

Mr. Riddell: I think certainly the choices that are made have to pass and have to be generally available, as well.

Mr. Mitchell I. Serota: I think that this is all well and good to produce things on a theoretical basis and we can have a wonderful discussion on how to apply the regulations as they are now (or as they're going to be), but it seems to me these very creative plans are opening up an incredible nightmare, as far as communications go.

How much communication do you have to give an employee so that he or she can make a well-considered choice? I mean, we can sit here all day long and discuss design because we can understand the concepts? How much do you think your salary is going to be increased in the next couple of years, or what do you see the market being? But to produce a report to employees saying, "We're offering you these wonderful choices, figure it out," I mean that's not right. Communications, I think, is a much a more important issue than creativity.

Mr. Riddell: Communication is certainly a key to making choice a successful program. I think that for the companies that simply impose a design change on their employees, there is often a lot of backlash from segments of the workforce who felt that they were disadvantaged. Where a choice is offered, the result is different.

In my experience working with a major company that offered a choice, its first way is to deliver a DC plan that gives the exact same benefits as its existing DB plan, at every age, every salary level, and every service point, but not increase their costs for this plan. And, of course, you go through several modeling exercises and eventually understand that if the people investing the DC plan assets don't earn what the professional investment manager for a DB plan would have earned, then there's a cost. Payment of lump sums also has a cost to it.

To get around this cost hurdle, it went ahead with a program that offered employees a onetime permanent choice between the DB plan that it had in place and a DC plan. The choice was made on a prospective basis, so that past service benefits still were provided under the DB plan. The DB/DC choice was very close, at typical interest rate or salary growth assumptions. Nonetheless, it went to extraordinary lengths to communicate the possible issues and range of outcomes to their employees. And that was part and parcel of the success of the program.

In addition to the workbooks and the normal communication tools, it used a video and provided interactive modeling tools. It also had workshops for every single employee and let the employees use work time to go to the workshops. Then it offered one-on-one financial counseling to every single one of its employees. In other words, it wanted to bend over backwards to make sure that employees had all the information (the resources, the time, and the professional support) they needed to make a choice, but at the end of the day the company wanted the employees to make a choice. As the choices came in, they were very much the pattern that you would have expected. The 55-year-olds chose, by and large, to stay with the DB plan; the 22-year-olds chose to go with the DC plan. Employee feedback was extremely favorable at the rollout and extremely favorable a couple of years later. The employees appear to be very comfortable with their election.

I can't emphasize enough how important the communication aspect is in the choice program. Down the road, someone will be unhappy with his or her choice. If we string together a few investment years like the year 2000, somebody who chose the DC side may think that earning 8% on his or her money was a fiction: "They should have known that I was only going to earn 2% on my money." Ten years down the road, there is a pretty big difference between accumulations at 8% and 2%.

Again, the communications program was coupled with an election review process to make sure that employees actually went to sessions, that they actually got counseling, that they actually signed forms, and that the materials used in the sessions were screened by the attorneys and were consistently given to every single employee, etc., so that the litigation defense framework was set up to show that the company had done everything it possibly could to help the employees make the best choice.

Mr. Rusin: Mitch, I would just add that I agree with your concern 100%. I think that the more exotic the plan design, the more difficult it is to communicate to employees and therefore the less likely employees will understand it. It is not a good program if it can't be understood, period. And to me, that puts a very realistic and relatively low ceiling on just how far you can go with one of these choice programs. We're all still waiting to hear what the outcome is going to be from Congress on cash-balance plans.

I think the debate is really centering around two issues. First, does the square peg fit into the round hole in terms of the rules and regulations for DB plans with issues such as age discrimination and accrual rates and so forth? The other issue is what is the proper disclosure and communication to employees at the time of this shift from one type of program to another, and if they do have a choice, which would be the better choice for them? Employee understanding is always an issue, and in my mind is paramount.

Mr. Rusin: There are some programs that permit not only the shift from DB to DC from year to year but also the transfer of employee monies and employee accounts from one program to another per the employee's election. The new rules on optional forms include some new voluntary transfer rules primarily directed at DC plans. If an employee is entitled to a distribution in the case of a DB plan, that would mean that he or she is terminating employment. In a DC plan, he or she must be at least 59.5 years of age if he or she is still in service and would then be eligible for distribution and a transfer between plans without a 411(d)(6) issue.

Mr. Riddell: When we think of things such as normal retirement ages, we might think of age 65 or age 62, but in certain circumstances you can define normal retirement age at something that wouldn't theoretically look like a retirement age anywhere other than in Silicon Valley (e.g., 5 years of service). And there, all of a sudden, you have the situation where, by promising a normal retirement benefit after just five years of service (which is also typically the vesting age), you can actually have an in-service distribution of a DB. That would allow you to release money from the DB plan to go into a DC plan or to go into a separate investment-type account.

Using this type of normal retirement definition is very difficult when you have more than one benefit formula or group of employees. In other words, this approach almost has to stand on its own from a coverage testing standpoint. You can't have a group that won't pass coverage on its own with this type of setup because typically it will not work when you go back to test the plans on an aggregated basis. Depending on the workforce dynamics that you have with the employer that's sponsoring a plan, you often find a situation where this is actually a very attractive way of delivering benefits. But defining normal retirement age as "any age with five years of service" is a bit awkward from a communication standpoint. I think many people look at that and scratch their heads, and try to understand exactly what that means.

Another example is the same approach to defining a retirement age after five years of service. It helps a couple of cash-balance plans where the interest credit is not linked to a particular index, but its employees choose which investment fund's return applies to their interest credits. This variable interest credit seems to make sense only in an environment in which you define normal retirement age after 5 years of service and you don't have a concern about the accrual rules and some of the other things that Notice 96-8 tried to address from the IRS's perspective.

Mr. Rusin: Another trend is that a number of employers are trying to get away from the concept of retirement altogether. That's really a pretty good mesh with what many employee interests are. Terms such as "phased retirement" or "gradual retirement" are gaining popularity. Many employers are looking at their workforce not looking to make or imply a lifetime commitment of employment. They're making a commitment to employability or to supplying challenging work as long as that work is available and fits the skills of the worker. They would like to get to the situation where there's a mutual understanding between employer and employee that employment is on a year-by-year or project-by-project basis. Thus, many retirement program designs focus on portability; for example, lump-sum distributions and hybrid plans. The elimination of annuity-type benefits and retiree medical benefits is consistent with the notion that once the employment relationship is severed, all connection with the employer ends. The employee walks away with a portable benefit. They haven't missed an eligibility cliff where a heavily subsidized early retirement benefit might have been available if they had stayed around an extra three or four years or whatever.

One organization structured their retirement program with portability and this disconnect concept in mind. In addition to providing a lump-sum distribution under the DB plan, they permitted money from the DC plan to be taken either in a lump sum or transferred to the DB plan for a purchase of additional pension benefit. What that did is create the opportunity for what they call full distribution flexibility where under the combined DC and DB program, the employee could choose anywhere from a 100% annuity benefit to a 100% lump-sum distribution or any point in-between. This gives tremendous flexibility to the employee at retirement. Some employees are very worried about outliving their retirement benefits. Other employees really want to receive a full distribution of benefits up-front, to continue to invest their money and have maximum flexibility on cash flow.

I think as Mitch pointed out, the key to this is again the level of communication and education that is provided around the choice. Even for a modestly paid worker, their 401(k) accumulation coupled with the account balance under a cash-balance plan or PEP can be a substantial sum of money and its disposal may be the most important financial election in that employee's life. And so again the amount of education that is given and support that's given is critical to the success of providing flexibility.

From the Floor: As far as the annual election to go back and forth between the two plans, I can see that being a big headache to administer. You have to provide ongoing education for your employees. What good reason would an employer have to offer annual election other than the annual flexibility itself to go back and forth between two plans?

Mr. Rusin: I think it's consistent with what an employer might be doing on the health and welfare side. As life situations change, as career direction changes, a variable approach to benefits is going to be more attractive. I've not worked with an annual choice plan, but my expectation is that there would not be very much variability in retirement plan elections from year to year. Those that are comfortable with DC would continually elect DC. Those that are comfortable with DB would stay with DB. I would expect more change on the welfare plan side as family status changes.

A number of employers want to label themselves as providing maximum flexibility. If the sponsor is already going through a great deal of administrative effort for its welfare cafeteria plan, it's not a big hurdle to administer choice on the retirement side. The sponsor can collect the elections and provide modeling through the Internet.

Ironically, when you think of all the programs that an employer can offer to its employees, the one with the least administration ends up being the classic DB plan. There's virtually no administration to be done until a participant terminates employment and so from an efficiency standpoint benefits are delivered with relatively little cost on the administration side. The public, however, has pretty well demonstrated that it's not terribly attracted to that type of benefit. There isn't much communication and really no employee participation. That's one reason why the trend to the more administrative and communication-intensive programs has taken place.

A few more points about employee choice and retirement plans. We talked earlier about moving DC money into a DB plan at retirement and buying additional DBs or annuity benefits as a final investment decision with respect to that money. One thing to note is that that option is likely to include favorable annuity conversion rates, favorable to the employee to entice money into the DB plan. The favorable annuity purchase rates generate additional DBs, but the current liability associated with those new benefits is probably going to be tied to lower interest rates, so a transfer could increase the plan's unfunded current liability. Taking that one step further, if there is any thought or plan for plan termination in the near term, the new benefits will be valued at more conservative annuity market or lump-sum rates at settlement and unfunded plan termination liabilities will go up as well.

Next item. We have all probably been exposed to public plans and the practice of picked-up contributions. That's one more example of employee choice. In the case of a rehired employee, the employee's choice is to either redeposit his or her earlier distribution to buy back past service credits or to have certain contributions picked up on a pretax basis. If the employee chooses the latter approach, it also eliminates the need for the government entity or plan to tract a tax basis for the individual.

We've talked some about disclosure and communication in general with employees. If there's an unusual plan design and/or significant employee choice, as there is, for example, in the context of a change to a cash-balance plan, communication is critical. The amount and level of that disclosure and communication, of course, is currently the subject of great debate in Washington and around the country. Something that's been with us for a much longer time and is raised by the Harkin Letter is the choice that the employee makes and its ramifications if there is a lump-sum option under a retirement plan. The issue is, how far do you have to go to explain to the employee that the true value of the lump sum may or may not include the value of an early retirement subsidy that the employee would enjoy if annuity payments were chosen?

Mr. Forstadt: Some of my comments are on this lump-sum issue but a little bit away from it. These are really two issues that I feel strongly about. First, in the conversion from a typical final pay plan to a cash-balance plan, the issue has arisen in the papers of frozen benefits. People don't accrue future benefits and that happens primarily because the rules for converting to a lump sum require you to use (what many people think is) an abnormally low interest rate; therefore, many people are converting at a higher interest rate so that the old benefits are frozen until you get a "catch-up."

Second, I have some strong feelings (and I think Mary would probably agree with me) that for retirees the DB plan is not something that's a bad thing, but rather a good thing, and I think there's an answer to this that I've not heard discussed. As far as I know, and the issue revolves around when you're converting a lump sum back into an annuity, you must convert both ways at the 30-year T-Bond rate. This gives you a lousy conversion back to an annuity but that's only really for the normal form, while the normal plan is a life annuity or a 50% joint and survivorship annuity (J&S). You can have another form, which is a modified cash refund annuity, either life or J&S, and you can use a subsidized lump-sum conversion rate for that. You could use, for instance, an 8% rate.

If you do that, what you're going to find for most people is that employee accruals are not frozen in the original conversion because you now have much more of an equality, and, second, you make taking an annuity from the cash-balance plan a far more attractive option. I think you can run some numbers and I've seen this at a previous Society section. It may be a rather attractive investment to take an annuity much more than most people would think, even perhaps actuaries, when you actually run the numbers. I think we'd be doing a favor to offer these kinds of choices and also improve our public relations. We would be doing a favor for plan participants to give them a better opportunity to select the DB option, because for many people this is an actually good investment.

Mr. Riddell: That's an interesting approach and a good point. Jack, I'm just thinking that in a traditional DB plan, of course, you make the present value conversion in the other direction. You have an annuity benefit and now, as an option, it can be converted into a lump sum at a favorable (low) rate, and the participant will typically choose the lump sum. Now, we're going in the other direction if we add the annuity feature to a cash-balance plan. I just wonder how attractive the annuity conversion and how large the annuity has to be to really make it a more attractive election than a lump sum equal to the account balance itself.

Mr. Forstadt: And the point I would make is that retirees (or people near retirement) that I've spoken to have two great fears. If they elect the lump sum, their great fear is that they'll outlive their income, and if they have the annuity, their great fear is that they're going to die shortly after the annuity starts.

Mr. Riddell: Your point about the modified cash refund annuity answers that, and that's a very important point and a good point.

Mr. Forstadt: And the discount for it at age 60 is really rather slight. It's not much of a discount for them. It's probably worth a lot if you die right away.

Mr. Riddell: For those of us who can remember pre-ERISA, before the J&S annuity was the normal form, probably the most common form of election was the five-year or a ten-year certain and life option, which is slightly less complex than the modified cash refund, but certainly of the same principle that even if you die shortly after you retire at least somebody gets a certain number of payments from the retirement program. I think that principle is still very important.

From the Floor: Well, I think you can set up a fairly sensible table that shows somebody how much they would have to earn on their lump sum to get an equivalent annuity, based upon how long they have to live. I am personally appalled when I read *The Wall Street Journal* and it talks about people's retirement situations. It assumes that everybody will die at their life expectancy because half the people won't die by then. Those people eat cat food after their money is gone.

Mr. Riddell: Actually, I had a client comment on that. I think that one of the things that helps a lot is the sophistication of the modeling tools that an employer can make available to an employee for modeling the choice between two options or just to plan out the usage of money over their retirement years. I remember walking through an illustration with a client, which showed that this person's $300,000 balance was expected to decline to $0 at about age 84. The client said, "Hah! That's when I move in with my kids!" Life expectancy is an extremely important issue in the distribution election. "How long will I live?" Of course, you don't know the answer, but you know what your tolerance for risk is.

While we're on the topic of retirement, I think one of the things that will be very important in the next couple of years is that we're seeing health-care costs take off again as they did really before the introduction of managed care, particularly prescription drugs. Absent the next president changing the Medicare mix, that's going to be an extremely important issue for those employers that still provide retiree medical benefits or simply have employees who are staying on to work longer because of the potential cost of their medical coverage in retirement. Many employers adopted caps on the retiree medical plans five or six years ago, maybe around the time of FAS 106 adoption. With the escalation in the health-care cost, we're going to see most of those employers hitting those caps very quickly, at which point you'll get under the terms of the caps, the full transfer of the additional costs increase to the employees in added premiums for their retirees' health coverage. That is simply a big issue that is coming soon. It's a cost issue for employers to address—determining whether they will continue to apply the caps as they originally scheduled, or to come through with additional benefits that will make the cost of the medical coverage palatable to the employees.

One of the trends has been to channel more and more of the prescription drug coverage into the generic drugs, where they're available, going to the generics first and then to whatever is available under the formulary and then the highest deductible or copay for the branded drugs. For most retiree health-care plans, half or more of the cost of the program is related to drugs.

Just talking with employers, and not taking into account investment performance this year, I think a greater number of employers are thinking very seriously about providing cost-of-living increases to their retirees. Many just feel this is long overdue. Although inflation for the last 10-15 years has been 2-4%, the accumulation of that has eroded the retirees' purchasing power greatly. The people who have been retiring recently had the opportunity to save under a 401(k) plan and are much less in need of cost-of-living adjustments to a pension. It's the people who retired in the 1970s and the 1980s, who really didn't have a DC plan to complement their DB plan (or who had very limited time to build up an account under the DC plan) who are really most at risk in terms of the purchasing power of their pensions. I see that definitely as a trend.

With 401(k) plans and other DC plans a very strong trend is the automatic enrollment of participants. A lot of communication and a lot of matching dollars have been thrown into 401(k) programs, and you still get a core of people, 30% for certain employers, who do not choose to enter the voluntary program to save money. The automatic enrollment forces people into the plan. They can still elect out, but it takes an election.

The second element that's come out in the marketplace is not only forcing employees into the plan, but also defaulting them into a correct investment decision. Typically, you may have a default election of a stable-value fund, which as most professionals would say is not the right investment for a 25-year-old in a retirement fund. The right investment is a diversified portfolio, pretty heavily weighted toward equities. There are firms that are starting to take the fiduciary risk to actually model a portfolio for every single employee. Then that becomes a very attractive default benefit for somebody who has been "forced" into the plan. The investment default to a professionally managed portfolio, on a mass production basis, takes into account age, pay, and Social Security benefits and other factors that are generally available.

The Internet-based investment advice from certain firms often links very closely with the daily valuation administration system. This is a very powerful tool for those people who want to think through how they are investing their DC money. They get effective access to what a professional would say about how their money should be allocated. But I think it still takes pushing a button to actually say, "Do what I'm supposed to do, rather than what my own risk tolerance tells me to do."

Mr. Riddell: I'll just add that the biggest point about automatic enrollment in the 401(k) plan or a negative election to participate is that it really goes contrary to everything we were talking about here. It's the opposite of employee choice, so we might just draw our own conclusion as to why that is also a trend in the marketplace versus the overall trend toward more employee choice, more employee responsibility, and so forth.

Mr. Rusin: Speaking of 401(k) plans, one of the other recent issues is the 401(k) safe harbor. That's been with us now for about a year and certainly I don't see a great groundswell toward adopting 401(k) safe harbors, but it probably will become more prevalent over time. As a trend, it's probably in its infancy. What I've seen personally is that the companies that adopted the safe harbor are the ones that already had the requirements for the safe harbor in place, at least in terms of cost. They already had a 3% money purchase feature in their plan or a very rich match. It's then just a matter of immediate vesting of those monies that may have a relatively small cost to them. There are a couple of things, though, that I would like to point out in the case of adopting a safe harbor when you have an existing program. The first one is that, when 401(k) plans are tested under the average deferred percentage (ADP) and average contribution percentage (ACP) tests, the definition of compensation eligible for deferral can be virtually anything from base compensation to total compensation, or anything in-between. Testing pay used in the ADP and ACP tests will correct for any discriminatory definition of eligible pay. If you move to a safe harbor, by definition, there are no tests so the definition of eligible pay may need to be revised as well and meet a 414(s) safe harbor.

Second, if you're modifying existing programs for the safe harbor, be sure plan eligibility conditions match. I had a situation where an existing money purchase plan would be used to satisfy the safe-harbor requirements. The 401(k) plan had negative elections and immediate participation; the money purchase plan had a one-year service requirement. There was no safe harbor for employees during their first year of employment. We had to modify and match the eligibility conditions of the two programs.

Also, the IRS has recently clarified that you can still meet the safe-harbor requirements for 401(k) testing if your match and/or nonelective contributions are done strictly on a payroll basis. In other words, there's no need for a true-up at year-end. That sounds like a good thing and something that eases administration, but keep in mind that there will be employee dissatisfaction if someone contributes at a very high rate early in the plan year and ends up not maximizing his or her match. Again, communication is needed to avoid that situation.

The last two items are stock options and disability policies in a DC plan. The initial reaction of the IRS was that stock options were acceptable. Again, it was difficult to find something in the Code or in the regulations that specifically prohibited it. The IRS has recently backed off from that position, looking both at the prohibited transaction regulations and just the idea of taking a tax deduction for something that was not truly contributed up-front.

Mr. Forstadt: I had a client in Boston about ten years ago who, in fact, was putting stock options into a DC plan with a letter with the IRS. I don't know if they continued to do that, but it was pretty attractive for a company, and as you know in the Boston area there are a lot of start-ups and young companies and they didn't have a lot of cash, but putting in options, which enabled people potentially to get a lot of benefits later, was pretty attractive for both them and the employees. It was implemented at least for a time. I haven't been in Boston for a long time now, but as far as I know, it's still going and I don't know if they've said anything about it. It presents some interesting problems with regard to allocation realization when you sell the options and what they're worth when people leave, but notwithstanding that, it's an interesting idea and I just wanted to let you know that it had been done at least once to my knowledge.

Mr. Rusin: The idea behind the purchase of a disability policy within a 401(k) plan is to protect and maintain continued contributions and credits when the individual is disabled. As I understand it, the premium for the disability coverage comes from current investment earnings that the employee's account would otherwise be credited with. When the disability feature kicks in, the contributions and matching money are not treated as annual additions but as investment income, so there are no nondiscrimination issues on the back side either.

Ms. Larsen: If a company adopts a plan where there's a choice on an annual basis between a DB and a DC plan, there's a need to test annually for nondiscrimination purposes ??as to?? every three years?

Mr. Riddell: It's a matter of whether there's been a significant change in the plan population or the nature of the plan benefits. If there's been a significant change from one year to the next in the elections that are actually made, then I think that a change in population and/or provisions has occurred and the plan sponsor cannot rely on triennial testing.

Ms. Larsen: Also, with these new IRS proposed regulations, if a company tests in the year 2000 and it's not a safe-harbor plan, if the new regulations are effective January 1, 2002, is there a need then to test under the new regulation one year early?

Mr. Riddell: The new regulation does not change any of the testing requirements per se; it really describes the structures of plans that can go through the old testing process or the minimum contributions that must be applied to go through the old testing process. But the testing process itself has not changed in the proposed regulation. I suspect that if you passed for the year 2000 and were hoping to rely on that for 2001 and 2002, that would be fine as long as your plan was structured so that it meets the requirements of the new regulations. Then the testing you did in the year 2000 should satisfy 2002, as long as there hasn't been a material change in the covered population.

I think that one thing that we find is that the three-year testing is very attractive for many of the designs that are pretty straightforward; where the result of the testing is that you're passing with a very healthy margin versus the thresholds. Where you're passing with a very modest differential, e.g., where the plan design has been pushed to provide the maximum benefit to a set of highly compensated employees, then typically you're in an annual testing mode anyway because the ability to pass or fail the test is highly dependent on a very small segment of the population. And unless you monitor that on a year-by-year basis, you do have some risks, but for most plans where it's a broad design, you can get away with a three-year testing pretty often.

Ms. Judy Feldman Anderson: A more general question. I'm just wondering whether the panelists and the audience have been witnessing moves toward later retirement ages? And you had mentioned, Dave, some interest in phased retirement. I'm wondering if that's become more common and if interest is rising about it given the type of job market now?

Mr. Riddell: Several years ago, I had anticipated later retirements and more of a trend toward phased retirement, but the statistics kept coming in that people were retiring early. I suspect this was quite heavily influenced by early retirement windows or just the overall generosity of a combined DC plan coupled with a very favorable investment market, so that people in their high 50s and low 60s had enough money to retire. At this point, you make the choice, would you rather fish and play golf or would you rather come back to the office and design retirement plans? You make your own choice.

I think it's very clear now that that we're seeing some of the effects on workers of the termination of DB plans in the 1970s and 1980s, which replaced oftentimes adequate DC plans, and the effect of employees not taking advantage of the stock market through the 1970-90s and really having just a fixed-income return. They've reached age 50 now and really don't have enough money to retire on (at the standard that they're hoping to retire on), at which point those people are forced to continue working in the current environment.

The good news is that there is a very robust employment market so there are tremendous opportunities to continue work. I think that a lot of people are realizing that retirement is not a fixed event anymore, and that you may change careers two or three times—not just businesses within your profession, but completely change careers. You may work on a part-time basis, on a contract basis, etc. For many people, those are very satisfying arrangements that they want to continue as a source of income and activity. I see a very strong trend toward continuing employment, but I also see a very strong trend away from the classic concept of retirement.

Mr. Forstadt: Just prior to retirement, I found it interesting (and I just retired a couple of months ago) that several of my employer clients were interested in redesigning their plan to eliminate subsidized early retirement and were pretty vocal notwithstanding the fact that they knew that they were going to get a lot of push-back. They needed people to work longer and certainly several others were very much interested in, and we did some studies on how people could continue working on a part-time basis, not full-time in this phased retirement if you will, and I know that there's some discussion in Congress on why somebody can quit firm A and work for firm B, get their DBs from firm A, but they can't keep working at firm A. That doesn't seem to be in the public interest necessarily. I think those are two trends (it's not statistically relevant, I know there are only a couple of examples), but I was surprised to see this trend among a number of my clients in the last year or so.

Rich, is the description for DROP correct? LB

Mr. Riddell: I think that there is some opportunity in the public sector for people to continue working but start their pension. I think there's something called the Deferred Retirement Option Plan (DROP) that allows you some of the benefits of phased retirement. But, like many things that are affected by the IRS regulations, and although we may have universal agreement here that it's logical that some sort of distribution of benefits in service can make a lot of sense, I suspect that it will take a long time for that to actually wind its way through Congress and get into a phased retirement bill that gets passed. I simply remember the Pension

Simplification Act that finally got passed a couple of years ago that was about as noncontroversial an act as I could imagine. Nonetheless, it took about five years to finally get the act attached to the correct bill that allowed it to be passed. For now you work within the nonqualified benefits framework to make a phased retirement possible. And that includes the employer's direct-pay program.

Ms. Adams: I just want to say I'm so glad I retired in the simple days of nice old DB plans that were all by themselves plus 401(k)s where you could get a big fat lump sum when you retired, and that gave you enough money to invest in tax-free municipals and keep a little bit to play with (it's been fun playing on the NASDAQ and a few things like that). You don't get rich but it's fun, and you don't have to worry about having to eat baked beans for a week even if your fund goes bad.