# CASH BALANCE LEGISLATION: MYTH VERSUS FACT

## MYTH # 1: EMPLOYERS PROTECT OLDER WORKERS FROM THE ADVERSE IMPACTS OF CONVERSIONS TO CASH BALANCE PLANS

FACT: While some employers have protected their employees from some of the worst adverse impacts of a conversion, even cash balance supporters have acknowledged that "it is not unusual in some cash balance conversions for the 40 to 50 year old employee to lose one-third to as much as one-half of his expected pension."[1] A study of actual cash balance conversions conducted by the actuarial firm Towers & Perrin determined that in over one-third of the conversions the employers provided no transition protections whatsoever.[2]

In 2002, a General Accounting Office (GAO) report documented the dramatic reduction in benefits for older workers:

> "a 45-year old worker at the time of conversion receives an annual annuity of about $18,500 at retirement from the cash balance plan instead of the $39,800 annuity the worker could have received from the defined benefit plan with a final average pay formula. Likewise, a worker 50 years old at conversion receives an annual annuity of about $17,800 from the cash balance plan rather than the $35,100 annuity the final average pay formula would have provided."---- 2002 GAO Report[3]

| AGE | BEFORE CONVERSION ANNUITY | AFTER CONVERSION TO CASH BALANCE ANNUITY |
|---|---|---|
| 45 | $39,800 | $18,500 (-$21,300) |
| 55 | $35,100 | $17,800 (-$17,300) |

Source: 2002 GAO Report

[1] Shapiro & Rachal, *Litigation Issues in Cash Balance Plans*, Benefits Link, (1999), http://benefitslink.com/articles/cashbalance.html..

[2] Arcady & Mellors, *Cash Balance Conversions*, JOURNAL OF ACCOUNTANCY (February 2000) http://www.aicpa.org/pubs/jofa/feb2000/arcady.htm

[3] General Accounting Office, *PRIVATE PENSIONS – Implications of Conversions to Cash Balance Plans*, GAO/HEHS-00-185, at 24-25 (Sept. 2000) (hereinafter "2002 GAO Report") http://www.gao.gov/new.items/he00185.pdf at 28.

To make matters worse, some employers structure their conversions so that older employees often work for months or years without accruing additional pension benefits while similarly situated younger employees continue to accrue benefits. During a typical conversion, many older workers experience what is referred to as "wearaway," which means that they continue working without earning additional pension benefits until the amount in their cash balance plan reaches the amount they had already earned under their traditional defined benefit plan. The GAO found that the amount of wearaway any employee experiences is tied directly to age.[4] Older workers suffer the longest periods of wearaway, which may last many years. For example, a typical conversion scenario "generated a 2-year lump sum wearaway for a 35-year old worker, a 4-year wearaway for a 45-year old worker, and an 11-year wearaway for a 55-year old worker at conversion." In such an instance, the 55-year old would earn no additional pension benefit before reaching normal retirement age, in effect working the last decade for no corresponding retirement benefit.

**MYTH #2: EMPLOYERS DID NOT REALIZE WHEN THEY CONVERTED TO CASH BALANCE PLANS THAT THE PLANS MIGHT VIOLATE AGE DISCRIMINATION LAWS.**

FACT: From the earliest days of cash balance plans, the employer community recognized the very serious legal issues posed by the age discriminatory aspects of hybrid plans. In fact, as early as the mid-1980s benefits consultants were "writing articles . . . panning cash balance plans, that they are a flash in the pan, that they are a gimmick, that they can't satisfy any of the rules."[5]

Significantly, following an early meeting of what later became known as the Cash Balance Practitioner's Group in 1990, attendees—which included representatives from four large pension consulting firms and two major law firms--circulated a memorandum acknowledging that "it is well known that a [cash balance] plan is at risk under a literal reading of" the age discrimination laws. The Working Group Report noted that a "number of practitioners believe that there is a very significant risk that the [Internal Revenue] Service will ultimately take the view that it cannot avoid a literal interpretation of the statute." The group concluded that in the absence of a "legislative fix," the "potential employer exposure is extremely high – potentially increasing the plan liabilities four or five times."

The concerns of the Working Group Report were subsequently confirmed in an Internal Revenue Service document indicating that Onan Corporation's cash balance plan was not in legal compliance: "This plan does not satisfy the clear and straightforward requirement of section

[4] 2002 GAO Report at 28.

[5] Lawrence J. Sher, 1999 Enrolled Actuaries Meeting (March 14-17, 1999).

411(b)(1)(H)(i) of the Code because the plan's benefit accrual rate decreases as a participant attains each additional year of age."[6]

**MYTH # 3: AUTHORIZING CASH BALANCE PLANS WON'T INCREASE THE PBGC'S LIABILITY EXPOSURE.**

FACT: Authorizing cash balance plans will create significant additional liability exposure for the PBGC at the very time Congress is acting to reduce that exposure. It is indeed ironic that cash balance advocates would suggest that provisions encouraging the use of cash balance plans would be added to legislation designed to reduce PBGC liability exposure and suggestions that cash balances plans are "like" 401(k) plans or defined contribution plans are grossly misleading as neither of those plans generate PBGC exposure. Cash balance plans generate significant additional liability exposure to the PBGC because the "leverage" inherent in a cash balance plan creates funding issues should all benefits come due immediately as would happen in the event of a bankruptcy.[7] This is because even though cash balance plans promise to pay participants a benefit at any point in time which is equal to the employee's account balance, the plans are funded by employers on the basis of "actuarial liability." The result is that, even when the plan is considered "fully funded" for PBGC purposes, the actuarial liability used for funding purposes will often be as little as 70% of the plan's current account balance liability thereby creating additional potential liability exposure to the PBGC.

In addition to increasing the liability exposure of the PBGC, authorizing cash balance plans leaves a myriad of issues unresolved in terms of what benefits the PBGC will provide to employees covered by cash balance plans in the event of bankruptcy. Employees should not be left to guess what their benefits would be in the event their company fails and they are forced to look to the PBGC to provide their hard earned retirement benefits.

**MYTH # 4: EMPLOYERS NEED CASH BALANCE PLANS TO APPEAL TO TODAY'S MORE MOBILE WORKFORCE.**

FACT: It is a total fiction that today's work force is more mobile. As Eric Lofgren, an actuary at Watson Wyatt, explained to the Society of Actuaries: "[B]aby boomers have had the same level of mobility as their parents and grandparents when you look at people at the same age. . . . So far the boomers have been staying on the job longer, actually, than their parents and their grandparents."[8] Mr. Lofgren's comments are consistent with a study conducted in 1998 by his

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[6] Letter from Andrew J. Fedders, IRS Employee Plan Specialist, to District Director of the Internal Revenue Service regarding the Onan Corporation Pension Plan, July 28, 1997.

[7] Actuarial Aspects of Cash Balance Plans for The Society of Actuaries by Bolton Offutt Donovan, Inc. (July 7, 2000) at 6, 34-38.

[8] Eric P. Lofgren, Remarks to the New York Annual Meeting of the Society of Actuaries (October 18-21, 1998).

firm which concluded that this phenomenon applied as well to younger workers, age 25 to 34, who in 1996 spent a considerably longer time, on average, with one employer than did workers in that same age group in the 1950's.[9] More recently, the authors in the largest research study to date of conversions to cash balance plans concluded that they had "found no support for claims that CB conversions are a response to labor markets with more mobile employees."[10]

**MYTH # 5: BY CONVERTING TO CASH BALANCE PLANS EMPLOYERS MAKE PENSIONS EASIER FOR THEIR EMPLOYEES TO UNDERSTAND AND APPRECIATE.**

FACT: More frequently, employers use a conversion to cash balance plans to hide benefit cutbacks. In 1986, shortly after the adoption of the first cash balance plan, Eric Lofgren, an actuary with Watson Wyatt, outlined for a conference of actuaries that a primary objective of conversions to a cash balance plan was to "to camouflage a benefit cutback, or remove early retirement subsidies."[11] Mr Lofgren even noted how a company converting to a cash balance plan could use two very different announcements for the same new cash balance plan. The upbeat version most commonly used to announce a conversion optimistically touts the purported virtues of a cash balance plan, describing it as "an exciting, modern, flexible new plan design with the advantages of both defined benefit and defined contribution." He also suggested what he described as an equally accurate, but more candid, definition:

> "Dear Employee: We've got for you a cash balance pension plan. It's our way to disguise the cutbacks in your benefits. First we're going to change it to career average. We'll express the benefits as lump sum so we can highlight the use of the CPI, a sub-market interest rate. What money is left in the plan will be directed towards employees who leave after just a few years. Just to make sure, we'll reduce early retirement subsidies."

This ability to use conversions to mask cutbacks was still being touted in 1998, when an actuary with PricewaterhouseCoopers noted to the annual meeting of the Society of Actuaries that "converting to a cash balance plan does have an advantage of it masks a lot of the changes."[12]

As a practical matter, conversions to cash balance plans also have been used to achieve artificial accounting gains. Existing accounting rules have allowed publicly held corporations to use cash balance conversions to generate "pension income." The company's increased bottom line presents a more attractive financial picture to the investing public. As Mark Beilke, chairman of the Academy of Actuaries Pension Accounting Committee, recently observed, financial statement "gains [from cash balance conversions are] mostly derived from 'accounting

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[9] *Workforce Management: The Cultural Shift,* Watson Wyatt Insider, Vol. 8, Issue 8, (August 1998).

[10] D'Souza, Jacob & Lougee, Why do Firms Convert to Cash Balance Pension Plans? An Empirical Investigation (December 2004)("Empirical Investigation").

[11] Remarks of Eric Lofgren, Vol. 12. No 1 Report of the Society of Actuaries, at 419 (1986).

[12] Remarks of William Torrie, 1998 Society of Actuaries Annual Meeting, quoted in Ward, *Eating their Words*, Plan Sponsor Magazine (March, 2000)

gimmicks.'"[13] Similarly, William Sweetnam, then a member of the Senate Finance Committee staff and later a Treasury Department Tax Benefits Counsel, acknowledged in 1998 that the "primary reason cash balance plans are financially advantageous is the accounting treatment of cash balance plans versus final average earnings plans . . . So the reason that cash balance plans are better is that they make the corporations [sic] financial statement look better since pension liabilities are less."[14] Warren Buffet has described the practice by some companies of creating "phantom" pension income to inflate reported income as a misrepresentation that "dwarfs the lies of Enron and WorldCom."[15]

**MYTH # 6: EMPLOYERS DO NOT ADOPT CASH BALANCE PLANS TO REDUCE THEIR COSTS AT THE EXPENSE OF OLDER WORKERS.**

FACT: Employers repeatedly have converted to cash balance plans as a way to reduce their costs at the expense of older workers' retirement benefits. For example, Chief Judge Murphy held in *IBM v. Cooper* that IBM's actuaries projected that IBM's 1999 conversion to a cash balance plan "would produce annual savings of almost $500 million by 2009."[16] Consistent with the voluminous anecdotal evidence, a survey of cash balance plan sponsors found that 56 % of firms expected the long-term cost of their defined benefit plans to decrease after conversion. Similarly, the largest study of cash balance conversions documented that "firms with employees who are closer to retirement are more likely to convert to the CB format." It also concluded that "the workplace of firms that undertake conversion to CB plans has had a longer tenure with the firm, on average" lending "credence to the claims of CB conversion opponents that firms benefit from these conversions at the expense of older workers." Empirical Investigation at 26

**MYTH # 7: IF LEGISLATION ALLOWING CONVERSIONS TO CASH BALANCE PLANS IS NOT RETROACTIVE SOME 1,600 LARGE PENSION PLANS WITH HYBRID PLANS ARE LIKELY TO EITHER FREEZE OR TERMINATE THEIR PLANS.**

FACT**:** It is first important to note that even if you define large employers as those as few as 1,000 employees, according to the PBGC there are only approximately 625 such employers with hybrid pension plans.

Putting aside the question of how many large employers have hybrid plans, it is clear that some employers and certain employer groups, such as ERIC, have threatened and will continue to threaten massive terminations in an attempt to scare Congress into giving them immunity for

[13] Comments posted as "MGB" on Discussion Forum, May 13, 2003. http://benefitslink.com/boards/index.php?act=Print&client=printer&f=22&t=19682

[14] E-mail from "Bill" Sweetnam to Stan Fendley, et al., dated 12-22-98.

[15] Buffet, Who Really Cooks the Books?, New York Times, Section A, page 19 (July 24, 2002).

[16] (Memorandum Opinion and Order at 16 (July 31, 2003).)

their prior illegal age discrimination. But whatever exposure they have today for their prior age discrimination, they will have the same exposure following the adoption of legislation without regard to whether they terminate or freeze their plan. In other words, prospective cash balance legislation would stop the growth of their future exposure but their existing exposure remains the same without regard to whether they continue, freeze or terminate their plan. In short, while it is a threat that the employers have used in the past and will undoubtedly continue to use, it is a red herring.

What most employers ignore is that all that retroactivity eliminates is the potential liability with respect to past conduct -- benefits that employees have already accrued. Employers and employer groups are also reluctant to admit that most employers did not provide the kind of transitional protections included in the Senate Finance Committee bill. In other words, they will also have to persuade Congress to eliminate transitional protections against wearaway and other abuses or they won't get any benefit from retroactivity language inserted in the bill.