STATEMENT OF THE U.S. CHAMBER OF COMMERCE

BY JOHN WOYKE

Good afternoon, Mr. Chairman and members of the committee. My name is John Woyke, and I am an attorney and enrolled actuary with Towers Perrin. I am here today on behalf of the United States Chamber of Commerce, on whose Employee Benefits Committee I serve. The Chamber represents over three million businesses of every size, sector, and region of the country.

I appreciate the opportunity to comment on cash balance plans, particularly as they relate to older workers.

Perspectives on Cash Balance Plans... Do They Discriminate Against Older Workers?

In the public debate over cash balance plans, one of the loudest complaints raised by opponents of these plans is the contention that they discriminate against older workers. The employees who testified to Congress during last year's highly publicized hearings seemed to tell a convincing story when they talked of the thousands of dollars that they said they had "lost" when their employer converted from a traditional final pay plan to a cash balance plan.

It's no secret that we live in a age in which more efficiently. So it was easy to believe that companies bad improve the bottom line by converting to a new pension plan design at, of older workers who typically cost the most in terms of pay and benefits.

Complex rules

But is this what's, going on? We offer an emphatic no! Real life is often complicated, and that's certainly the case when it comes to understanding how pension plans work, and particularly how benefit calculations are made in plan conversion situations. Determining how much, to credit to the new cash balance accounts of employees depends on key benefit policy decisions in the context of the employer's financial management strategy as well as highly technical assumptions and calculations. Moreover, there are specific laws and regulations that employers must .follow to be fair to their employees, and that includes making sure that there's no discrimination against older employees in the accrual and distribution of pension benefits.

So let's take a close look at the law and the regulation designed to protect older workers against discrimination in the calculation and delivery of pension benefits -- and see what employers must do when they adopt cash balance plan.

Is the law

The legal requirements protecting against discrimination based on age derive from Section 411(b)(1)(H) of the tax code, which forbids a defined benefit plan from reducing an employee's rate of benefit accrual with increasing age. The Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act of 1967 (ADEA) contain parallel provisions.

Cash balance plans, of course, express the benefit as a contribution credit to an individual's account each year, generally as a percentage of pay. Typically, these credits range from 4% to 8% of pay, and the account grows over time as the credits accumulate and generate investment earnings specified by the plan. The actual credits may vary depending on age and service, or employers may use a fixed rate for all employee accounts. Whatever the design, these plans have the look of a defined contribution (DC) plan, making them easy to understand even though technically they are defined benefit (DB) plans. They're simple to understand, and they appeal to younger employees because the retirement benefit accumulates steadily -- in contrast to final pay plans that are "backloaded" to provide the greatest reward to employees with many years of service.

In fact, many cash balance plans are "front-loaded." While this has a particular technical meaning as far as the IRS is concerned, a look at Chart A is one way to show this conceptually. Here we compare a traditional defined benefit plan that provides an accrual of 1% of pay per year of service with a cash balance plan that provides a contribution credit of 5% for each year of service. The chart shows how much annuity, beginning at age 65, the value of each accrual will buy. Here we see a contribution credit in the cash balance plan "buys" progressively less in terms of an annuity, because as an employee approaches normal retirement age, each year the account balance will have less time to earn interest credits.

Opponents of cash balance plans point to this falling line to argue the plans discriminate against workers as they get older. Proponents point out, however, that the rate of benefit accrual *as defined by contribution credits* for a typical cash balance plan stays level year after year. Because the rate stays the same as an employee gets older, there is no discrimination. All employees get the same percentage of pay set aside their accounts.

Even if cash balance plans were discriminatory (and we certainly believe they're not), what would this mean in practical terms for employers and employees saving plans? *If defined contribution plans were held to the same standard*, it would mean that virtually all 401(k) plans discriminate against older workers because their accounts are structured in the same way as cash balance plans, with a contribution based on a fixed percentage of pay. This is, of course, an absurd result, but it would be the logical extension of accepting the argument of cash balance opponents.

Intent and practice

In the preamble to the final non-discrimination regulations (Regs. 1.401(a)(4)-l through -13), the Treasury Department and the IRS noted the way interest credits accumulate in a cash balance plan and expressly rejected the age discrimination argument. In addition, the regulations implicitly approve front-loaded cash balance plans by providing a safe harbor for plans with a uniform contribution rate -- perhaps the most common type of plan design.

The discrimination argument, of course, diverts discussion from the more easily understood nature of cash balance plans, as shown in Chart B. Here it's clear that the value of the accruals in the cash balance plan are greater for younger workers than under the traditional plan. The chart illustrates why many younger works like cash balance plans which can provide more for workers who change jobs and take their account balances with them.

Wear-away

Another argument used by opponents of cash balance plans is based on the "wear-away" phenomenon that can occur with some employees when a company calculates the value of the frozen accrued benefit when converting from a traditional pay plan to a cash balance plan. If the new account balance is less than the value of the accrued benefit, the employee has to work for some period to make up the difference. For technical reasons related to early retirement subsidies, and the fact that traditional plans are heavily backloaded, older and mid-career employees may be subject to more wear-away than younger workers when the employer converts to a cash balance plan. Indeed, many younger workers may not experience any wear-away at all.

For example, let's consider an older employee with an opening account balance of $190,000, whereas the lump sum value of his previous accrued benefit was $200,000. Let's also consider a younger worker with fewer years of service who has an opening account of $9,500, also equal to 95% of the lump sum value of his previous accrued benefit. Clearly, it will take a longer period for the older employee to "make up" the $10,000 "shortfall" than it will for the younger worker to make up a $500 "shortfall." Again, cash balance opponents say this is age discrimination.

That argument is too simplistic and overlooks what's really going on. The length of the wear-away period is generally not a function of an employee's age, but rather an employee's pay history and length of service. And it is clear under the law that a benefit adjustment based on one or more factors that generally correlate with age is not based on age discrimination. Moreover, an employee's age is quite distinct from years of service. So even if a wear-away period were considered a reduction in the rate of benefit accrual, there would not be a violation of section 411(b)(1) because the benefit formula is based on pay history and service, not age.

Furthermore, the prior benefits may not have been available in the form of a lump sum and, therefore, may not have been portable. It is true that the actual benefit received can never be less than that which was previously accrued. *The issue here is about increases in accrued benefits going forward. There are no takeaways in cash balance conversions*.

We've focused on some rather narrow, technical issues to try and explain some of the points that come up when there is a discussion of age discrimination in connection with cash balance plan conversions. However, what's perhaps more important to understand in these situations is that employers typically adopt a variety of approaches to create an entirely new retirement benefit structure for employees. If they seek to replace a traditional final pay plan with a cash balance plan, in most cases they provide transition benefits for mid-career and older employees who are most affected. These can take the form of "grandfathering" current employees under the old plan, providing additional credits in their cash balance accounts, or guaranteeing a minimum benefit based on the prior formula. Moreover, in many cases an employer's shift to a cash balance plan is part of a complete overhaul in retirement strategy that may include additional awards of stock or a higher contribution to the company's 401(k) plan.

We continue to believe that it is up to employers to decide what retirement strategy works best for them within a total financial management framework. Obviously, different *industries and companies will tend to take different approaches based on their business objectives, resources and overall philosophy about rewarding employees and helping them prepare for retirement. Cash balance plans are one such approach.

Flexible approaches

Even with the popularity of 401(k) and other defined contribution plans, as well as the growing use of stock to reward employees, the vast majority of Fortune 1000 companies continue to sponsor DB plans. Indeed, research indicates that employees tend to prefer DB plans over DC plans as they advance in their careers, grow older, and realize the importance of preparing for retirement. Cash balance plans have proved attractive by combining features of both approaches-with regular contributions that are appreciated by the employee and a stream of guaranteed income M*sulated from investment risk.

As with any pension plan, cash balance plans must be described carefully and fully to employees. In this context, employers have a responsibility that includes proper disclosure about how these plans work, especially in conversion situations. We believe employees have a right to be notified when their employer is adopting a cash balance plan, and to receive an easily understandable statement of accrued and projected benefits. But any changes to the current pension systern, which is highly regulated, must be made with care. Cash balance plans should be allowed to stand on their own merits, and employers must be allowed to remain flexible and adopt creative benefit strategies for their employees in a rapidly changing, competitive marketplace.