Testimony of Laurel Sweatt

Good morning and thank you, Mr. Chairman, for the opportunity to appear today. I am Laurel Sweatt, and I am the Manager of Benefits for the Central and South West Corporation. Central and South West Corporation (CSW) is a Dallas-based public utility holding company that owns four U.S. electric utility subsidiaries with 1.8 million customers, a regional electricity company serving 2 million customers in the United Kingdom, and non-utility subsidiaries involved in energy-related investments, as well as subsidiaries that offer telecommunications, energy efficiency and financial transaction services. American Electric Power of Columbus, Ohio and CSW announced their intention to merge on Dec. 22, 1997. The merger will create a company with approximately 38,000 megawatts of generating capacity in the United States, more than 4.7 million customers in 11 states and approximately 4 million customers outside the U.S.

I am also here this afternoon representing APPWP - The Benefits Association. APPWP is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, APPWP's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

I will begin my remarks this afternoon with a discussion of the state of our defined benefit pension system. Cash balance plans are defined benefit plans, and both these plans and the legislative initiatives they have generated should be evaluated in the context of our defined benefit system as a whole. I will next turn briefly to the reasons employers have moved to cash balance and other hybrid designs as well as to companies' efforts to address the needs of longer-service workers during these transitions. I will then discuss our specific conversion experience at Central and South West. The remainder of my remarks will be devoted primarily to a discussion of the various legislative proposals concerning cash balance plans. I will conclude with some brief remarks about the age discrimination issues that have been raised in connection with cash balance plans and conversions.

The Defined Benefit Plan Context

In APPWP's view, the discussion about cash balance plans should be placed in the context of the defined benefit pension system as a whole. APPWP's member companies believe that defined benefit plans continue to play an important role in America's retirement system. These plans place funding responsibility and investment risk on employers, insure benefits through the Pension Benefit Guaranty Corporation (PBGC), and provide annuitized lifetime benefit options. These features add up to meaningful retirement security for America's working families and have led many policymakers in the Administration and in Congress to champion defined benefit plans. Nevertheless, our defined benefit system is in decline.

While not always the case, traditional defined benefit plans are often underappreciated and misunderstood by employees. For example, in an internal employee survey performed by one of APPWP's member companies, the *employee fitness center* was rated as a more valuable benefit than the traditional defined benefit pension plan. As you can imagine, the fitness center is vastly less expensive and less complicated to operate than the pension plan. In many instances, traditional final average pay defined benefit plans also provide limited incentive and security to employees in an economy where the average duration of an individual's tenure with a firm is only 3.6 years. This abbreviated tenure is also reflected in the interest of many employees in "short-horizon" benefits, such as 401(k) plans, health insurance, stock options, and cafeteria plans. Employers need to reassess the use of benefit dollars that are providing benefits that are underappreciated by large groups of their employees. Moreover, defined benefit plans have been over-legislated and over-regulated. Plans and administrative practices must be constantly adjusted to reflect these annual legislative and regulatory changes. Legal, actuarial, accounting, and other fees associated with these changes are prohibitively high for many employers.

Given these realities, it is not surprising that the PBGC reports that since 1985 the number of defined benefit plans it insures has dropped from 114,000 to 44,000 and that, according to the Department of Labor, the percentage of active American workers covered by defined benefit plans has fallen from 38 percent in 1980 to 23 percent in 1995. Cash balance and other hybrid defined benefit plans have been the one hopeful sign amid this ominous trend toward plan termination. These hybrid defined benefit plans preserve the design and policy advantages of traditional defined benefit plans while responding to current marketplace demands for features traditionally associated with 401(k) and other defined contribution plans. We believe that cash balance and other hybrid plans should be viewed as a critically important mechanism for keeping defined benefit plans relevant and vital in today's changing economy.

Why Cash Balance Plans and Other Hybrid Plans Have Been Attractive

In the recent public debate, the discussion about why companies have converted to cash balance and other hybrid plans has focused almost exclusively on cost considerations. Yet we have found that, among our APPWP member companies, cost is only one of many factors considered as part of the decision to redesign a pension plan -- sometimes it is an important motive in the change and sometimes it is not. As the Watson Wyatt analysis discussed earlier in today's hearing reveals, in many instances cost has not been a primary factor in the decision to convert[(1)]and in many cases costs have not, in fact, decreased.[(2)] For many companies, conversions have been part of an overall redesign of benefits and compensation programs that has not resulted in reduced expenses.[(3)] For example, conversion of the underlying pension plan is often accompanied by institution of a stock option plan, payment of higher cash compensation or an increase in the level of company match to a 401(k) plan. In many instances, this reallocation of benefit dollars is driven by the fact that these other forms of compensation are often valued more highly by employees than the underlying pension benefit.

Other factors motivating employers to move to hybrid designs include the desire to provide the portability, individual accounts and even accrual pattern that the majority of workers are telling companies they want. Plan sponsors have concluded that, in many cases, hybrid plans better meet the needs of their particular company's workforce. The modern features of cash balance plans help companies attract and retain employees in a world where many competitor firms offer exclusively defined contribution and stock plans, which have proven to be very popular with today's workers.[(4)] With their account design, cash balance plans also tend to be much easier to communicate to employees than traditional plans and, as noted above, this has been an important factor for employers. This clearer picture provided by cash balance plans means employees are better equipped to monitor progress toward their retirement savings goals and to determine the level of 401(k) contributions and/or other personal savings that may be needed to supplement their underlying pension benefit.

Some critics of cash balance conversions have suggested employer motives other than those outlined above, maintaining that employers have converted their plans merely to obtain and spend the surplus assets that may exist in the company's defined benefit pension plan. Yet nothing about a conversion grants employers access to these pension surpluses for non-pension purposes. Employers face very severe excise taxes (as well as income taxes) if they attempt to withdraw pension surpluses to spend for general corporate purposes. These substantial and effective tax barriers to the use of pension surpluses remain in place before, during and after a conversion to a cash balance pension plan. The only non-pension purpose for which defined benefit surpluses may be used without penalty is to fund retiree medical expenses in certain very limited situations. Believing this to be a wise and worker-friendly use of pension surpluses, Congress late last year extended this provision of law. The bottom line is that cash balance conversions allow no new or special access by employers to pension surpluses.

These same critics also charge that companies convert to cash balance plans to cut pension costs and increase pension surpluses, thereby inappropriately boosting corporate profits. First, as discussed above, in many instances cash balance conversions do not reduce costs and so do not boost pension surplus levels. Second, and perhaps even more important, the role of pension surpluses in corporate profits is not some inappropriate effort at manipulation by employers but rather is required under the accounting guidelines of the Financial Accounting Standards Board (FASB). Under the Statement of Financial Accounting Standards No. 87, pension surpluses contribute to corporate income in the same way that pension liabilities contribute to corporate losses.

How Transitions Have Been Handled

Most companies spend considerable time and energy designing transition provisions to assist workers nearing retirement age who may not accrue as much in benefits going forward in the cash balance plan as they would have under the prior plan. Under current law, employees have a protected legal entitlement at the conversion to all the benefits they have already earned. Indeed, this protection of earned benefits is one of the core principles of ERISA. The transition benefits provided by the employer are in addition to these protected earned benefits. The types of transition benefits employers provide vary, but include:

- "grandfathering" some or even all employees in the prior pension plan formula;
- providing additional pay or interest credits in the cash balance plan for a period of years or until retirement;
- allowing some population of employees to choose to remain under the prior plan formula; or
- providing workers with additional amounts in their opening cash balance accounts.

As discussed above, many employers also enhance their defined contribution or other benefit and compensation plans as part of the conversion process, which can aid in the effort to assist longer-service workers.

A recent analysis of 100 cash balance conversions conducted by PricewaterhouseCoopers reveals that nearly all companies offer at least one of the transition benefits described above. Indeed, in 81% of the conversions some or all of the employees were grandfathered in the prior plan, offered choice between the prior and the new plans, or provided transition pay credits. In the remaining 19% of cases, almost all companies provided other transition assistance such as more generous opening account balances for some workers or an ongoing system of pay credits that increased by age or service.[5] Provision of these benefits belies the notion that companies engage in conversions in a cavalier manner, disregarding the concerns and interests of their longer-service employees. Rather, companies recognize the potential for lessened benefit earnings by mid- and late-career employees and provide the transition assistance described above to ameliorate these effects.

The Central and South West Experience

Mr. Chairman, let me now take a moment to describe the CSW conversion to a cash balance plan. CSW made changes to its defined benefit and defined contribution plans effective July 1, 1997. The changes included converting the traditional defined benefit plan to a cash balance pension plan and increasing the company match in the defined contribution plan. The changes made were due to employee needs expressed in surveys and focus groups as well as CSW's changing business needs. CSW received a favorable determination letter from the IRS for both the cash balance defined benefit plan and the defined contribution plan in August of 1999.

First, I would like to explain the process we used in the design of the cash balance defined benefit plan and the enhancements to the defined contribution plan. A team of employees from CSW was asked to evaluate both plans and to determine whether the plans were meeting the diverse needs of employees as well as CSW's changing business and workforce needs. The team discovered that the economic value provided by the prior traditional defined benefit plan was significantly higher than the value provided by corporate defined benefit plans generally. For example, the automatic cost of living adjustment (COLA) included in our prior plan is offered by less than 2% of Fortune 500 companies. The COLA provision resulted in a significantly higher economic value to employees than the value offered by corporate plans generally. In addition, the employee team found that the economic value of the defined contribution plan was less than the industry standard and that employees wanted more value from this plan. Instead of simply bringing the economic value of the two plans in line with industry standards, the team looked for other ways to develop value for employees. Cash balance added value by being easy to understand, by providing employees payment options that were available immediately (including a lump sum), and by expanding the benefits for beneficiaries.

Our purpose in converting to a cash balance plan and enhancing the defined contribution plan was not primarily to save money. The conversion to cash balance did create expense savings primarily through the elimination of the cost of living adjustment. We were prepared to eliminate the automatic cost of living adjustment even without the conversion to cash balance. Our cash costs for 1998, 1999, and 2000 were higher than before the changes. We anticipate that cash costs will continue to be higher in future years.

In the conversion, we wanted to minimize any detrimental impact on employees especially during the first five years. In order to do this:

- CSW used a lower than market interest rate in converting the accrued benefit - the lower interest rate created a higher opening cash balance than the lump-sum interest rate required under law;
- CSW calculated employee benefits both under the prior plan and also as if the workers had always been in the cash balance plan - over 50% of employees were provided with the higher balance that resulted from applying the cash balance formula to all years of their service;
- CSW added 13% of base pay to the accounts of all employees who were age 40 or over and had completed 5 years of service;
- CSW gave employees age 50 or over with at least 10 years of service a choice of the prior pension formula or the cash balance formula - employees make this choice when they retire;
- CSW enhanced the protected benefit earned as of the time of the conversion by adding in the full value of the automatic cost of living adjustment to the benefit earned as of July 1, 1997 (instead of having a protected annuity with an automatic cost of living adjustments each year). To include the full value of the COLA in the protected benefit, CSW assumed all employees would retire at age 55 and live to age 110, receiving the full value of the cost of living adjustment each year. This added approximately 30% of additional value to the protected benefit in the early years of payment.

Even with these enhancements to the protected benefit, at conversion less than 2% of employees had a protected benefit that was higher than their projected cash balance benefit. The employees who could have had a potentially higher annuity benefit under the prior plan protected benefit are generally our high paid, long service employees.

As a final note, since conversion, a majority of departing employees have chosen to take a lump-sum payment of their benefit. This includes the employees who are currently grandfathered into the prior plan. In addition, with our merger close at hand, many employees will unfortunately be losing their jobs. In most instances, these employees have a better pension benefit as a result of the conversion to cash balance.

Legislative Proposals

Mr. Chairman, APPWP believes that the appropriate legislative response to the concerns that have been raised about cash balance conversions is to enhance the disclosure requirements of current law. Specifically, APPWP believes that current law can and should be improved to ensure that employees are provided with additional information about how their retirement benefits are affected by a conversion to a hybrid plan. However, we believe that moving beyond disclosure enhancements to impose new benefit mandates, as some have suggested, would be an inappropriate and counterproductive response. Such mandates would: (1) deter the use of innovative pension designs such as cash balance that better fit the American workforce, (2) hasten the decline of defined benefit pensions with their valuable retirement security features, and (3) undermine some of the basic premises of our voluntary pension system that have encouraged employers to offer pension benefits to their employees.

We at APPWP are also concerned that many of the legislative proposals regarding cash balance plans are overbroad. These bills generally fail to limit their burdensome requirements to the conversions that are the stated justification for the proposals. Instead, they impose these requirements on a broad range of defined benefit plan changes outside the conversion context. Changes such as revising the percent of pay used in a benefit formula, excluding bonuses and overtime from the definition of compensation, revising a Social Security offset, or changing how a plan credits service (e.g., from elapsed time to counting hours of service) -- all common defined benefit plan changes having nothing to do with conversion to a new hybrid design -- are changes that would trigger many of the new requirements the bills seek to impose. This overbroad response will interfere with employers' ability to manage their traditional defined benefit plans and risks accelerating the departure of employers from the defined benefit system. With the defined benefit system in decline and policymakers appropriately focused on how to revitalize it, legislation in this area should be narrowly focused to address clearly identified problems. Unfortunately, many of the cash balance proposals currently under consideration are broad in their application and reach into areas where no concerns have been raised. In the context of congressional efforts to foster simplicity in our pension laws and encourage new pension coverage and improved pension benefits, this is precisely the wrong course to take.

With these general principles as background, let me now turn to a more detailed discussion of the specific legislation that has been introduced.

Disclosure Legislation

We at APPWP believe that changes to the disclosure rules should focus on enhancing disclosure requirements when employers convert to a cash balance or other hybrid design (or make similarly fundamental changes in the plan's structure). While some modest enhancements may also be appropriate to the disclosure rules that accompany pension plan amendments generally, legislation should not impose complicated new disclosure requirements on the many common and straightforward defined benefit plan changes that can also reduce future benefit accruals for some participants.

We believe that the most effective way to provide additional information to employees about how the conversion to a cash balance plan will affect them is through an extensive set of illustrative examples that demonstrate how various representative types of workers will fare under the new plan relative to the old plan. These extensive examples would illustrate the effects of the conversion on workers of different tenure, age, and pay and would show how the two plans would compare for these categories of workers at different points in the future. These extensive illustrative examples should be accompanied by a description in words that explains the effect of the amendment on the different representative groups of workers. Such an approach - extensive illustrative examples plus prose disclosure - would be extremely helpful in informing employees about how they will fare under the conversion.

We believe that individualized benefit statements would be of only marginal additional use to employees relative to these extensive illustrative examples. Moreover, we believe that it will be extremely difficult to craft workable disclosure legislation that imposes on plan sponsors a requirement for individualized statements detailing how each employee's benefit will be affected. While we understand the desire to provide employees with personalized information of this kind, the practical difficulties associated with translating this ideal into the real world of plan operation and administration are extraordinary. The marginal additional usefulness of such statements relative to illustrative examples does not justify the tremendous additional human and financial resources that would be necessary even to attempt to comply with an individualized statement requirement.

Let me turn to a more detailed discussion of the practical difficulties associated with producing such statements. The individualized statement requirements under discussion by Congress require calculation of individual employees' accrued benefits (and, under many proposals, individualized projections and comparisons as well). An accrued benefit is the precise dollar amount of the retirement payment an individual employee has earned. Even in today's increasingly systemized and computerized world, calculation of this dollar amount for many employees, often between 15% and 20% of a workforce, requires considerable manual work. This is because computer systems do not contain many of the personal circumstances and factors -- such as qualified domestic relations orders (QDROs), offsets from another retirement plan, prior leaves of absence, grandfathered benefits from an acquired company, periods of service abroad, to name but a few -- that apply to a substantial number of a company's workers and that have an important effect on the amount of those individuals' accrued benefit. Production of potentially tens of thousands of accrued benefit statements in a period of weeks or months following the conversion (to say nothing of projections and comparisons), as many of the legislative proposals would require, simply will not be possible absent the dedication of truly extraordinary amounts of additional human and financial resources by employers.[(6)]

Mr. Chairman, as you are aware, the tax legislation passed by Congress last summer and the pending minimum wage legislation already approved by the Senate contain a provision to expand disclosure requirements when defined benefit plan amendments reduce future benefit accruals. This provision would require employers to provide a description of the effect of the plan change on representative classes of employees prior to the amendment and, for fundamental changes such as conversions, would require employers to provide some individual information after the amendment becomes effective. Importantly, this provision draws a critical distinction between conversions and equivalently fundamental plan design changes (which would trigger more extensive notice requirements) and simpler and more transparent defined benefit plan changes (which would be subject instead to a more modest requirement to describe how the amendment would affect employees). While imposing less severe timelines for individual information than other proposals, the provision does impose a requirement for individualized accrued benefit statements, which for the reasons discussed above we believe will be extremely difficult to satisfy. However, we believe the structure and approach of this disclosure provision is quite reasonable and we look forward to continuing to work through these issues with you and other interested Senators.

Another leading disclosure proposal is the bill introduced by Senators Daniel Patrick Moynihan and Jim Jeffords in October 1999 (S. 1708), which was prepared in close cooperation with the Clinton

Administration. We believe that this bill reflects much careful and thoughtful consideration of disclosure and administrative issues and makes a number of important improvements to the prior disclosure legislation offered by Senator Moynihan (S. 659). However, we believe that a number of additional issues need to be resolved if the disclosure regime contained in S. 1708 is to be made workable. First, the bill's extensive disclosure requirements apply to all defined benefit plan amendments reducing benefits, subject to the Treasury Secretary's authority to set simplified requirements for certain amendments. We believe it is critical that this be reversed. The extensive requirements should apply only to conversions to hybrid plans and, to the extent provided by the Secretary, other fundamental design changes. Second, the bill authorizes individuals to request personalized accrued benefit statements as well as projections and comparisons under the old and new plan formulas. As discussed above, such a requirement will be nearly impossible to satisfy. Third, much of the information required to be disclosed by the bill will need to be based on certain assumptions regarding the future. If such assumptions are reasonable and clearly disclosed, employers and plans should be expressly protected from any liability based on the fact that such assumptions (and the projections premised on such assumptions) differed from actual outcomes. Fourth, the bill requires the provision, on request, of "non-personal" information sufficient to enable individuals to prepare their own benefit estimates and projections. This is a vague and unadministrable requirement. The bill should instead require the provision of all factors other than plan offsets (such as benefit formulas and actuarial factors) contained in the plan document that are used to determine projected benefits.

This discussion makes clear that enhancing disclosure for employees whose pension is converted to a cash balance plan raises a number of extremely challenging technical and administrative issues. With that being said, we remain committed, Mr. Chairman, to working with you and other Senators to develop and enact practical disclosure legislation that will provide employees with the information they need to understand these important changes to their pension plans.

Benefit Accrual Legislation

One of the other cash balance issues that has received attention and spawned legislation is so-called "wear-away," which is the benefit plateau effect that can sometimes accompany cash balance conversions. When employers change to a cash balance plan, they typically provide an opening balance in the cash balance account. The benefit plateau results if the value of the employee's cash balance account is less than the value of the benefit he accrued under the prior plan as of the time of the conversion. Until the value of the cash balance account catches up to the value of the previously accrued benefit, it is the higher accrued benefit to which the worker is entitled -- hence the term "plateau." While this benefit plateau results from valid and appropriate actions taken by the employer in connection with interest rate anomalies and early retirement subsidies (discussed in detail below), it can nonetheless be confusing and even upsetting to employees. We believe the appropriate way to remedy this confusion and concern is through enhanced disclosure. For the reasons outlined below, we believe the legislation that has been introduced to prohibit such benefit plateaus would unwisely limit plan design flexibility, would lead to benefit reductions for workers in some situations, and would create additional incentives for employers to depart the defined benefit system.

Before turning to our comments on the legislation that would ban these plateaus, let me briefly discuss what causes them.

The first cause of the benefit plateaus is simply the effect of interest rates changing in the economy as a whole. The lump sum value of the benefit earned prior to the conversion will increase as interest rates fall. (This is because it will take a larger pool of money to grow to an equivalent benefit at age 65 if that pool will be earning less in interest.) The result can be that although a worker's previously earned benefit and opening cash balance account were both equal to $50,000 at the time of conversion, a decrease in interest rates can increase the value of the previously earned benefit to $55,000. Until the cash balance account reaches $55,000, this worker will experience a benefit plateau.

The second cause of benefit plateaus is employers setting the value of the opening cash balance account by using an interest rate higher than the U.S. Treasury Department's "lump sum" interest rate to discount the value of the already earned age 65 benefit. When this is done, the value of the opening cash balance account will be lower than the lump sum value of the previously earned benefit, meaning that workers will plateau at the higher level until the cash balance account catches up. Employers generally use a higher interest rate when they believe that the Treasury rate is historically low and the actual interest credits made to employees' accounts will be substantially higher. This use of higher interest rates has received substantial attention and criticism in the media. Yet the clear trend in recent years has been for employers to determine opening account balances using the Treasury rate or a rate more favorable for employees.(7) Thus, while employers using higher interest rates -- which has resulted in lower opening balances -- has received substantial attention, this phenomenon is not widespread today and so is not a frequent cause of benefit plateaus.

The third cause of benefit plateaus is the elimination of early retirement subsidies from the pension plan going forward.(8) A plateau can result because workers who have already earned a portion of an early retirement subsidy prior to a conversion will typically have a previously earned benefit under the old plan that is higher than the opening cash balance account (which is typically based on the normal retirement age benefit and does not include the value of early retirement subsidies).(9) Elimination of the early retirement subsidies going forward appears today to be the prime cause of benefit plateaus in most conversion cases where plateaus are seen. While some may be concerned about this phenomenon, Mr. Chairman, we feel strongly that employers must maintain their flexibility to eliminate these early retirement subsidies on a going forward basis. Given the acute labor shortage that we are experiencing today, it makes absolutely no sense for companies to continue to offer highly-productive employees rich financial incentives to retire in their 50s. While current law protects any subsidy that employees have already earned, it wisely allows employers to remove such incentives from their plan going forward. Any change in this policy would substantially worsen the already difficult task American companies face in retaining the workforce necessary to remain fully productive and competitive.(10)

The leading legislation to prohibit the benefit plateau effect is Senator Tom Harkin's S.1600, previously introduced as S. 1300. This legislation would ban benefit plateaus by mandating that benefits earned after a plan amendment be added to benefits earned under the pre-amendment formula. This same plateau prohibition is also contained in Senator Wellstone's S. 1640 discussed below. Despite the stated intent to address cash balance conversions, this benefit plateau prohibition is drafted more broadly and would reach a wide range of defined benefit changes outside the conversion context.

At the outset it should be noted that the use of benefit plateaus as a method of transitioning between benefit formulas has been expressly approved under the law for many years. Indeed, plateau periods can result from constructive and necessary plan changes, such as updating plan mortality assumptions to provide more accurate benefits, aligning the benefits of employees from different companies in the wake of business acquisitions and mergers, or revising a plan to meet new statutory requirements (such as legislative restrictions on the amount of benefits that may be paid under a plan). The ability of employers to make these necessary or desirable changes would be impaired by S. 1600.

Moreover, in the context of both traditional defined benefit plans and hybrid plans, substantial additional complexity would result from a prohibition on benefit plateaus. Such a prohibition and the corresponding requirement to separately track pre- and post-amendment benefits would require employers to maintain an extraordinary amount of outdated data in order to calculate benefits under both the prior and amended formulas. The extraordinary nature of the burden associated with a ban on plateaus is best understood in the context of almost any large company that is buying and selling businesses on a consistent basis. If the benefit formula and underlying data for every acquired business's plan must be preserved until the last "acquired" employee retires, that could mean retaining perhaps 30 or 40 different formulas with different underlying data for a period of 45 or more years.

In cases where an employer is acquiring part of another business, the burden that a plateau prohibition would impose could prompt the acquiring company to understandably decline to accept assets from the acquired business's plan. Accordingly, the former employees of the acquired company would start out as new participants in the acquiring company's plan, rather than receiving credit for past service under the former plan. The lack of past service credit in the acquiring company's plan can, in turn, have a very detrimental effect on the benefits ultimately received by these employees. Without past service credit, their benefits attributable to service with the acquired company will be provided by the former plan and will be based only on compensation earned with the acquired company. If past service credit is provided, however, their benefits attributable to the same service would be based on their final compensation with the acquiring company, which can be far greater. Thus, the plateau ban and the resulting decision of the acquiring company to decline to accept the former plan's assets leads directly to what can be a dramatic decrease in benefits for employees.

Finally, the plateau prohibition creates an extremely rigid set of requirements that would make it much more difficult to communicate and explain benefits to employees following a conversion from a traditional defined benefit plan to a cash balance plan. Rather than being able to express an employee's entire benefit as a balance in the cash balance account, an employer would have to describe two benefit components, one from the old plan -- typically an annuity -- and one from the new -- typically a lump sum value. Such difficulties and complexities are precisely what cash balance plans were designed to remedy; they are not what an overly complex defined benefit system needs.

The debate over cash balance conversions has also generated benefit mandate legislation even more aggressive than S. 1600. Senator Paul Wellstone has introduced legislation (S. 1640) that would require employers changing from a traditional defined benefit plan to a cash balance defined benefit plan to offer all employees the option to remain in the prior plan. Moreover, employers not converting to a cash balance plan but making other defined benefit plan amendments that could reduce future benefit accruals would be required to offer vested employees the choice to remain in the prior plan or face an excise tax equal to 50% of the defined benefit plan's surplus. We at APPWP oppose such legislation in the strongest manner and believe it would lead to the unraveling of our employer-sponsored retirement system.

Under the measure, employees would have the right to reject the effect of any plan amendment that reduces future benefit accruals and the employee could instead remain under the prior plan formula. By restricting employers' ability to alter future benefit levels, the choice of plan mandate would mark a fundamental departure from our voluntary employer-sponsored pension system. Employers would find it virtually impossible to reduce future benefit levels in their defined benefit plans since workers could simply reject the plan amendments that carry out such reductions. Yet business circumstances (such as increased international competition, the presence of competitor firms with no pension expense, possible company bankruptcy, the need to attract new workers through alternative designs, or a general employee desire to reallocate benefit dollars to other programs - e.g., health benefits, a 401(k) plan or stock options) sometimes necessitate adjustments to pension plans. These retirement plan changes are certainly preferable to the possible alternative of outright termination of the plan, or, worse yet, the loss of jobs.

The consequence for an employer of initiating, continuing or improving a pension plan under a choice of plan mandate would be an ongoing financial commitment that generally could not be adjusted, irrespective of future competitive or business pressures. Prudent businesspeople, unable to predict either the financial future or the future preference of some employees to have their benefit dollars allocated differently, simply will not lock themselves into these unalterable benefits commitments. As a result, new pension coverage would be stalled, pension benefits would not be improved, and many employers would be prompted to terminate their existing defined benefit pension plans. These unfortunate results run directly counter to ongoing bipartisan efforts in Congress to broaden pension coverage to more working Americans and to improve existing pension benefits.

Age Discrimination

Mr. Chairman, before concluding, let me offer a few brief comments on the charge by some cash balance critics that the cash balance design and conversions to cash balance plans violate the pension age discrimination rules contained in parallel provisions of the Internal Revenue Code, the Employee Retirement Income Security Act and the Age Discrimination in Employment Act (ADEA). APPWP has responded to these charges in great detail in our recent comment letter to the Internal Revenue Service, which we have shared with your staff and which I ask be included in the record. So I will touch on only a few key points today.

We at APPWP believe the claim that the cash balance design itself is inherently age discriminatory is flawed as a conceptual matter and incorrect as a matter of law. At the conceptual level, the claim produces a distinction without substance between defined contribution plans such as 401(k)s and cash balance plans. In the critics' view, a defined contribution plan that has the same contribution rate for all workers would not discriminate on the basis of age while a cash balance plan with the same contribution rate for all workers would. Conceptually and from a policy perspective, this distinction cannot be justified.

Turning to the legal authorities, the statutory age prohibitions dictate that the "rate of an employee's benefit accrual" may not be reduced because of age. Under clear principles of statutory construction, this "rate of an employee's benefit accrual" refers to the rate of accrual spelled out in the plan document, which in the case of a cash balance plan is the rate of contributions made to the employee's cash balance account. Because these cash balance contributions do not decrease with age (and, in fact, sometimes increase with age), there is no violation of the pension age discrimination rules. Some have argued that the age prohibitions should be read differently to apply not to the rate of accrual spelled out in the plan document but rather to the annual benefit payable at normal retirement age. Such an argument is flatly inconsistent with the statutory structure. Moreover, such a reading would render substantially all contributory defined benefit plans age discriminatory and would require *increased* rates of accrual after normal retirement age in traditional defined benefit plans. Congress clearly did not intend these results.

Beyond the claim regarding the cash balance design itself, some have also charged that the benefit plateau effect that can sometimes accompany cash balance conversions violates the pension age discrimination rules. These critics charge that older employees typically have the longest benefit plateau periods. The answer to this contention is that the length of the plateau period is predominantly a function of an employee's length of service and pay history rather than an employee's age. It is certainly true that long-service workers tend to be older, which explains why older employees generally have the longest plateau periods. However, it is clear under the age discrimination law that a benefit plateau based on one or more factors -- such as length of service -- that generally correlate with age does not constitute age discrimination.

Some have also suggested that not reflecting the value of an early retirement subsidy in an opening account balance (and thereby producing a longer benefit plateau period for the workers whose previously earned benefit as of the conversion contains a subsidy) violates the age prohibitions because age is generally one of the criteria for the subsidy (e.g., attainment of age 55 and 10 years of service). Yet the age rules of the Internal Revenue Code, ERISA and the ADEA explicitly state that the effect of early retirement subsidies is disregarded in applying the age discrimination prohibitions.[(11)]

Because these age discrimination arguments fail, we certainly urge Congress to resist any legislation that would treat cash balance plans or conversions as age discriminatory.

Conclusion

As this Committee continues its deliberations on the issues surrounding cash balance and other hybrid plans, APPWP recommends carefully crafted disclosure reform, not overbroad benefit mandates, as the appropriate policy response to cash balance conversions. While we support enhanced disclosure and commit to work with you toward this goal, we believe that benefit mandates will drive employers to forego cash balance plans and will risk the termination of defined benefit plans of all varieties. Such results would run directly counter to the concerted work of many in Congress, including many members of this Committee, to expand the number of Americans with pension coverage.

Thank you again, Mr. Chairman, for the opportunity to appear today. I would be pleased to answer any questions you may have.

1. Of 79 employers surveyed as to their motives for converting, only 39% indicated that reducing plan costs was an important or very important consideration. The desire for more stable costs (57%) and the desire to better manage retirement expense (59%) were somewhat more important factors. Of the 17 possible employer motives explored in the survey, the cost reduction motive ranked 15th, the more stable costs motive ranked 11th and the managing retirement expense motive ranked 10th. The top three factors motivating the conversion were improving employee appreciation of the plan (cited by 96% of employers), facilitating communication about the plan (93%) and an ability to show benefits as lump sum values (93%). Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

2. In the 78 conversions analyzed by Watson Wyatt, 45% of employers realized some cost savings while 37% saw costs increase and 18% experienced a minimal effect on costs. Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans. Watson Wyatt Worldwide, February 2000.

3. In a recent survey conducted by PricewaterhouseCoopers of companies that had converted to cash balance plans, 67% of respondents indicated that the overall costs of the new retirement program (including any changes to the 401(k) and similar plans) were expected to be the same or greater over the long-term than the program being modified. The percentage is modestly higher -- 70% -- when considering short-term costs. PricewaterhouseCoopers, Cash Balance Notes, May 2000.

4. In Watson Wyatt's survey, 81% of employers cited aiding employee recruitment and 62% cited aiding employee retention as important or very important motives behind the conversion to a cash balance plan. 60% cited a desire to make the plan look more like a 401(k). Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

5. PricewaterhouseCoopers, Cash Balance Notes, May 2000.

6. Even with such investment, the potential for inaccuracies under these circumstances would be substantial, thereby undermining the very purpose of the individualized statements.

7. In its recent cash balance study, Watson Wyatt reports that of the 24 plans it reviewed that have converted to a hybrid design since 1994, 22 of them (92%) have set opening account balances using the Treasury rate or a rate more beneficial to employees. Sylvester J. Schieber, et al., The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift From Traditional Pensions to Hybrid Plans, Watson Wyatt Worldwide, February 2000.

8. An early retirement subsidy provides an enhanced benefit if the employee leaves the company at a specified time prior to normal retirement age. For example, a fully subsidized early retirement benefit might provide an employee the same pension at age 55, say, $1,500 per month, that he would not normally receive until age 65. The ability to earn the higher pension without any actuarial discount for the additional 10 years provides a strong financial incentive to retire at the earlier age.

9. Opening account balances do not typically include the value of early retirement subsidies because doing so would provide the value of the subsidy to a large number of workers who will work until normal retirement age and therefore not be entitled to the subsidized early retirement benefits.

10. Moreover, any legislative requirement that employers maintain early retirement subsidies in private-sector pension plans would be out of step with congressional actions regarding our nation's public pension system, Social Security. With respect to Social Security, Congress has raised the retirement age and repealed the earnings test in order to encourage older Americans to work longer. Requiring employers to continue to offer rich private pension plan incentives to retire early would be flatly inconsistent with these actions.

11. Internal Revenue Code section 411(b)(1)(H)(iv); ERISA section 204(b)(1)(H)(v); ADEA section 4(i)(6). Conceptually, the longer plateau periods for employees who have qualified for an early retirement subsidy is similar to the effect of an early retirement subsidy under a traditional defined benefit plan. The value of an early retirement subsidy decreases in the years following the year in which an employee first qualifies for the subsidy. Accordingly, under a traditional plan, an employee's net additional accruals in the years immediately after he or she qualifies for the subsidy are effectively lower than they were before he or she qualified for the subsidy. The parallel statutory provisions cited above provide that this effect, which is attributable to the subsidy, is disregarded for age discrimination purposes. Similarly, the longer plateau period, which is also attributable to the subsidy, is likewise disregarded. Any effort to outlaw the plateau period attributable to the effect of the subsidy in the conversion context would seem to unwisely endanger the use of early retirement subsidies in *traditional* defined benefit plans.