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SUMMARY

The ADEA, and companion provisions in the Code and ERISA, prohibit the ***reduction*** in (or cessation of) benefit accruals based on age. The overall objectives of these provisions are two-fold: to assure that pension plans do not discriminate on the basis of age and to remove disincentives to older employees to remain in the workforce. In general, cash balance plans violate both the letter and spirit of these provisions. As a result, both the cash balance formula itself, as well as a conversion of a traditional plan to a cash balance plan, violate current law.

There is no dispute that cash balance plans are, by definition, defined benefit plans. Cash balance plans must therefore operate according to the laws and rules governing defined benefit plans. From that fundamental proposition every other requirement follows: cash balance plans must define their benefit in terms of an annuity commencing at normal retirement age; cash balance plans may not provide a single sum benefit that is less than the present value of the normal retirement annuity; the present value must be calculated using stated actuarial assumptions that are consistent with the statutory limits; benefits must accrue at a rate that satisfies the anti-backloading requirements; and, benefits must not accrue at a rate that reduces benefit accruals based on age.

It is a mathematical fact that, absent other offsetting factors, a cash balance plan with a uniform hypothetical allocation and interest credit rate will provide lower benefit accruals to employees solely because of their age.

In addition, in a conversion, employees (particularly older longer service employees) may experience a period of time when no new benefits are accrued (the "wearaway"). While salary and service may be components in determining a wearaway, all else being equal, age is the determining factor of the amount of wearaway. Because the calculation of the wearaway is based directly on age, it also violates the pension accrual laws.

For older workers, absent transition relief (e.g., "grandfathering" employees in the old plan), the conversion to a cash balance plan is extremely detrimental. By depriving older workers û especially those with long service û of the benefit of their increased years of service and their peak earning years (including any early retirement subsidies), employers who convert break the implicit promises made to older workers in the traditional defined benefit pension plan. These employees may have made career and retirement decisions based upon the expectation of certain benefits, only to see that expectation disappear -- replaced by the new cash balance plan formula that reduces û or eliminates -- benefits based on age.

Some promote the design of cash balance plans as a beneficial hybrid of the common features of a traditional defined benefit and a defined contribution plan. But the problems for older workers caught in a conversion of a current defined benefit plan outweigh any potential benefit of the cash balance design. As we address the legal and policy issues raised by cash balance plans, we must protect older workers.

AARP is pleased with the opportunity to present its views on the important issues raised by the recent trend towards converting a traditional defined benefit pension plan to a "cash balance" pension plan. AARP has become increasingly concerned about the significant age discrimination issues that arise both within the cash balance formula itself and when employers convert defined benefit pension plans from a traditional formula to a cash balance formula. Cash balance plans per se reduce benefit accruals for older workers. Furthermore, depending upon the design of the plan conversion, the change to a cash balance formula results in a legally impermissible reduction in the rate of benefit accrual, often including a period of many years when older workers accrue no additional retirement benefits whatsoever. In general, older workers are most harmed by a conversion, and have less time to recover from a conversion and concomitant loss of retirement benefits, because they are closer to retirement and cannot save enough to make up this loss.

AARP believes that a careful review of the legal distinctions between defined benefit and defined contribution plans makes clear that the most common designs for cash balance plans violate the benefit accrual provisions of the Internal Revenue Code (Code), the Age Discrimination in Employment Act (ADEA), and Employee Retirement Income Security Act (ERISA).

I. THE ADEA PROHIBITS AGE DISCRIMINATION IN PENSION PLANS

Section 4(i) of the ADEA prohibits the reduction in (or cessation of) benefit accruals based on age. ADEA § 4(i) and its companion sections in the Code and ERISA, enacted in 1986, highlight Congressional concern about fairness to older workers in the operations of pension plans. The overall objectives of the amendment were two-fold: to assure that employee pension benefit plans do not discriminate on the basis of age and to remove disincentives to older employees to remain in the workforce, *see* 29 USC § 623(i). Prior to OBRA, many plans made older workers face a cruel choice û retire, or watch the value of their retirement benefits erode substantially.

The legislative history of OBRA demonstrates Congress's concern about the diminished value of pension benefits for older workers whose accruals may be reduced or ceased based upon their age. Indeed, Congress engaged in a sophisticated balancing of the significant and substantial benefits of continued benefit accruals to older workers (as well as the potential savings to the federal Treasury due to continued employment of those workers), against any costs to employers for providing such accruals. Senator Charles Grassley (R-IA), the primary sponsor of the OBRA amendment requiring continued accruals, engaged in precisely this type of analysis. More importantly, the initial Senate amendmentÆs language limited to post-age 65 accruals eventually gave way to the broader prohibitions against discrimination based on age that was enacted as part of OBRA.

In enacting OBRA, Congress clearly recognized that defined benefit and defined contribution plans, and their accrual methods, are fundamentally different. Accordingly, OBRA contains two differently-worded sections: one prohibiting the cessation or reduction of *accruals* in defined benefit pension plans (*see* fn. 1, *supra*), and one prohibiting the cessation or reduction of allocations in defined contribution plans.

II. CASH BALANCE PLANS ARE DEFINED BENEFIT PLANS AND MUST DEFINE THE BENEFIT IN TERMS OF AN ANNUITY PAYABLE AT RETIREMENT

Cash balance plans are defined benefit plans that have been repackaged to look like defined contribution plans. "Even though the cash balance plan resembles a defined contribution plan, it is as a matter of law a defined benefit plan." However, instead of defining the benefit in terms of an annuity payable at retirement, as traditional defined benefit plans must do, cash balance plans attempt to portray a participant's benefit as a lump sum amount which increases over time. Because of this repackaging, a number of features that usually distinguish defined contribution and defined benefit plans have been blurred, further concealing numerous legal, technical, and policy issues. The conversion of a traditional defined benefit plan to a cash balance plan formula raises additional legal and policy issues, and results in a range of winners and losers.

Since cash balance plans are defined benefit plans, the accrued benefit must be "expressed in the form of an annual benefit commencing at normal retirement age....," 29 USC § 1002(23)(A), or its actuarial equivalent. *See* 29 USC § 1054(c)(3); 411(a)(7)(A)(i); Treas. Reg. 1.411(a) -7(a)(1). The benefits are determined by the formula set out in the plan, not by the assets that may accumulate in one's "hypothetical account." As with all other defined benefit plans, the Code imposes upon cash balance plans rules governing the timing of benefit accruals, valuation of benefits, the certainty of benefit determinations, and rules governing the expression of accrued benefits, among other requirements. *See* Code § § 411(b)(1), 417(e), 401(a)(25) and 411(a)(7)(i). These requirements are all designed to ensure that the promise made to employees of a stream of payments to replace the wages lost at retirement is not rendered illusory by deceptive or ill-advised plan designs.

In most cash balance plans, the benefit is defined by reference to a "hypothetical account." The hypothetical account is attributed with an annual pay credit (usually a percentage of pay, such as 5 percent of pay each year), plus a hypothetical rate of return (usually tied to an index, such as the 30-year Treasury bond rate) on the assets. As in all defined benefit plans -- and to highlight the hypothetical nature of these "individual accounts" -- the employer is permitted flexible funding, meaning at any given time there may be more benefits promised in the hypothetical accounts than there are assets in the plan.

Generally, when an individual retires, the benefit must be converted to an annuity at the price specified in the plan. In addition, upon termination of employment, cash balance plans generally permit employees to take a lump sum. However, since the amount of the lump sum is determined by the plan formula and certain requirements in the law, the actual lump sum payment may be different than the amount in the hypothetical account.

Similar to other defined benefit plans, the employer contributes assets to the cash balance plan and manages the plan. The employer contribution obligation depends upon its estimate of the present value of total future benefit obligations, not on fixed or promised annual contributions to individual accounts. Depending upon the accuracy of its estimates on cost and the plan's investment returns, the employer's contribution obligation (if any) changes every year. *Nachman Corp. v. Pension Benefit Guaranty Corp.*, 446 U.S. 359, 363 n. 5 (1980). Employers generally assume the investment risk, but if plan returns are better than needed to fund benefits, employers also receive the rewards. Since defined benefit plan rules allow for flexible funding, any investment difference can be made up over several years.

III. THE REASONS EMPLOYERS CONVERT TO A CASH BALANCE PLAN

The explosion of cash balance plans has been almost entirely the result of conversions from existing traditional defined benefit plans. An estimated twenty percent (20%) of the Fortune 100 companies have converted their plans, covering close to 10 million workers. In a survey published last year, the magazine PENSIONS & INVESTMENTS stated that at least 325 companies had converted to cash balance plans with holdings of a minimum of $334 billion in assets.

There is no question that the movement to cash balance plans has been prompted by a desire to reduce pension obligations as the demographic bulge of "baby boomers" nears retirement û and hence moves through the years of greatest pension cost to employers (and greatest pension value to the employees).

Among reasons employers convert to cash balance plans:

- To save money, reduce overall plan costs, and limit their future benefit obligations to aging workers;
- To redistribute the benefits under the plan from older longer service workers to younger and newer workers;

- To eliminate early retirement subsidies from the plan;
- To avoid income and excise taxes if a defined benefit plan is terminated;
- To take advantage of the "spread" between what employers promise in interest credits and what the plan actually earns (the interest arbitrage); and
- To increase employee appreciation, since many employers believe that the traditional defined benefit plan is not well-understood.

IV. THE ADVERSE IMPACT OF CONVERSIONS ON OLDER WORKERS: BREAKING THE PENSION PROMISE

For employees, the change in plan design to a cash balance plan can have significant impact. For older workers, absent transition relief, it is almost always extremely detrimental. By depriving older workers -- especially long service older workers -- of the benefit of their increased years of service and their peak earning years (including any early retirement subsidies), employers who make this dramatic plan change break the implicit promises made to older workers in the

traditional defined benefit pension plan. These employees may have made career and retirement decisions based upon the expectation of a certain pension benefit, only to see that expectation disappear -- replaced by the new cash balance plan formula under which their age precludes them from earning comparable benefits. In addition, some older workers may suffer a wearaway period -- a period of time when no new benefits are accrued under the new plan. Older workers thus experience a double whammy -- loss of the more beneficial defined benefit formula, as well as the lack of time to benefit from the new plan formula (with the potential for no new benefits at all).

The conversion to a cash balance plan thus adversely affects older, longer service workers in several ways:

- It deprives them of the benefits derived from long service and a higher salary they would have received in the traditional defined benefit plan. A traditional defined benefit plan generally has a benefit formula that is based on number of years worked and final average salary. In addition, the annuity value is determined by number of years from retirement age *with greater value for those closest to normal retirement age*. This design provides smaller value in the early years of employment, with the greatest value coming in the last years of employment. Older workers are rewarded under this type of formula, especially if they are long-service workers. Younger, more mobile workers receive less value from this plan design. A younger worker covered by a traditional formula, in addition to being many years from retirement age, generally has a lower salary and a smaller number of years of service. The result is a small benefit after only a few years of work. As one begins to approach retirement age, and as one's salary and number of years in the plan increase, benefits begin to grow more dramatically. The bulk of benefits can be expected in the years just prior to retirement.
- It deprives them of early retirement subsidies often provided in traditional plans. The effect of increasing age and higher salary can be magnified by eligibility for an early retirement subsidy. Many traditional defined benefit plans include such a subsidy, generally based on number of years of service and/or age. Older employees who become eligible for these subsidies can see an additional spike in the value of their pensions. Many conversions include the elimination of these subsidies. In addition, when employers convert to a cash balance formula and choose an opening account balance for the new plan, the employer often ignores the value of the early retirement subsidy in computing the actuarial equivalent of the old plan benefit.
- Depending upon the conversion formula, older workers may be subject to a significant "wearaway," causing them to work for many years before earning any additional retirement benefits. Compounding the adverse impact of the change in benefit formula, the benefits under the

new plan, in essence, may take many years to catch up to the benefits already earned under the old plan formula. During this catch-up period, the employee would accrue no new benefits. This stands in sharp contrast to the expectation that their final years of service would result in the greatest increase in their retirement benefits.

- Older workers are disadvantaged because they have fewer years in which to accumulate significant pension amounts under the cash balance formula. A typical cash balance formula provides for a much larger accrual of benefits at an earlier age than a traditional defined benefit plan. Since a younger employee has a longer period of time before normal retirement age, the amount in the plan's hypothetical account will continue to earn interest credits for a much longer period of time, leading to greater benefits. Fewer years until normal retirement age means older workers have less compounding and thus smaller benefits.

As a result, the conversion to a cash balance formula has the practical and substantive effect of often dramatically reducing or ceasing accruals to the pensions of older and/or long service workers. Older employees have reported reductions in their expected benefits in the tens and even hundreds of thousands of dollars. In contrast, younger workers who had accumulated little under the prior plan design, may see a significantly higher accrual rate.

An employee accepts small benefits in the early years of the traditional plan in return for the promise of greater benefits as one continues to work. The change in plan design to a cash balance plan undermines completely that benefit trade-off. Older workers find that having completed those years in the traditional plan when benefits were small -- and having now reached the stage when benefits will begin to grow considerably -- the conversion to the cash balance plan no longer provides those expected higher benefits. Despite having worked for years under a plan design that gave small benefits at the beginning but promised higher benefits at the end of one's career, these same employees are suddenly switched to a pension package that provides the very opposite.

Many employers, having recognized the adverse impact on older workers in a plan conversion, have employed a variety of mechanisms in an effort to minimize the harm. For example, some employers have given current workers the option of remaining under the old plan formula. This generally ensures that an older, longer service worker is not hurt in a transition from one plan design to another. However, there is no requirement to offer such a choice. While extending such a choice is one option to protect older workers, too few companies have provided for plan choice, and fewer still extend that choice to all workers. Most often, that choice is for a limited period of time, and only to those older workers closest to retirement age.

Other companies have recognized that, since older workers have fewer years prior to retirement age to accumulate benefits under the new plan design, the formula should be adjusted to give a higher pay credit to older workers. While such provisions at least recognize that older workers have been adversely impacted by the conversion, enhanced credits generally do not make the older worker "whole" by providing benefits equal to that which would have been provided under the old plan.

V. RATES OF ACCRUAL IN A CASH BALANCE PLAN ARE REDUCED AS A PARTICIPANT AGES

A. Accrual Rates in Traditional Defined Benefit Plans

In virtually all traditional defined benefit plans, the *rate of benefit accrual* either (a) remains the same for all employees regardless of age, or (b) increases based on age (limited by the statutory rules on backloading). In addition, in a traditional defined benefit plan, the actuarial present value (also referred to as the "lump sum" value) of each year's accrual increases as the employee approaches normal retirement age. These increases in value are caused, in part, by *increases* in salary for older workers which are "typically earned in the worker's final years of employment." The increase in value of later accruals is further escalated in plans that provide a subsidized early retirement benefit.

B. The Reduction of Benefit Accrual in Cash Balance Plans

On the surface, cash balance plans seek to mimic the operations of a defined contribution plan by establishing hypothetical "individual accounts" representing an individual employee's accrued pension benefit. Typically, a participant in a cash balance plan receives annual interest and compensation credit. Each participant has a hypothetical account balance which increases annually as hypothetical allocations of interest and compensation occur. The plans typically define the benefit as the single sum amount of each employee's hypothetical account balance. When a participant in a cash balance plan reaches retirement, the account is converted to an annuity at the annuity price specified in the plan.

But, cash balance plans are not defined contribution plans. Because the benefit is not expressed in the form of an annual benefit commencing at normal retirement age (as is required for a defined benefit plan), the Service stated in IRS Notice 96-8 that cash balance plans would have to provide the actuarial equivalent of a benefit expressed in such a form and described how that is to be accomplished: a cash balance plan must determine the benefits payable at normal retirement age by reference to the hypothetical account balance as of normal retirement age, "*including benefits attributable to interest credits to that age*." See IRS Notice 96-8, 1996-6 IRB 23 at 24 (emphasis added).

Despite some protests to the contrary, Notice 96-8 is correct: the interest credits are the essential component of the accruals in a cash balance plan. Defined benefit plans require a present determination of what the benefit will be worth to the employee at age 65. The only way for a cash balance plan to be consistent with the required operations of a defined benefit plan is to utilize future interest credits in the calculation of accrued benefits.

If future interest credits were not included in the current calculation of the accrued benefits, but were accrued only in future years, the compounding over time would dramatically increase the amount of accruals in future years. As a result of this compounding, cash balance plans would inevitably run afoul of the "backloading" limitations set forth in the Code.

The following table shows the benefit accrual pattern (as a percentage of salary), by age, under a cash balance plan providing for a pay credit of 5% per year and an interest credit equal to 6% to normal retirement age.

Rate of Benefit Accrual Declines with Age*

Age	Pay Credit During Year	Projected Value at Normal Retirement Age	Benefit Accrual At Normal Retirement Age	Rate of Benefit Accrual
30	$2,000	$15,372	$1,444	3.6%
40	$2,000	8,584	716	1.8%
50	$2,000	4,793	450	1.1%
60	$2,000	2,676	251	0.6%

Source: *Poulin Associates, Inc.*

* Assumes annual earnings of $40,000; Normal Retirement Age of 65; Pay Credit of 5%; Interest Credit of 6%; Discount Rate of 6%; Mortality According to GATT

As evident from this table, the accruals vary directly with the age of the participating employees notwithstanding comparable salaries. In contrast to traditional defined benefit pension plans, where the accrual rates are either constant or increase based on age, the accrual rates in cash balance plans decline dramatically based on age when all other factors are constant.

The reduction in the accrual rate is an inevitable result of the method by which future interest is allocable to the hypothetical compensation credits in the year in which the contribution occurs.

While similar contributions and interest allocations would be permissible in a defined contribution plan, defined contribution plans are plans based solely on the amount contributed to the participant's individual account, and any gains or losses allocated to such account. See IRC § 414(i). There is no corresponding requirement in defined contribution plans to calculate the present value of future obligations because there are none.

As noted repeatedly, however, cash balance plans are not defined contribution plans. Benefits in a cash balance plan are not based upon actual account balances, but are determined by use of the benefit formula in the plan. Benefits in the hypothetical account are not related to the investment yield of the plan's assets. The hypothetical account is not credited with gains or losses, and the amount of assets in the cash balance plan may be more or less than the total value of the cumulative amounts in the hypothetical accounts. It is fundamental to the notion of the defined benefit plan, including the cash balance plan, that the benefit is referenced to the plan formula based on normal retirement age, not the account balance. This is the fundamental flaw in the cash balance design.

In short, the "savings account" accrual pattern that cash balance plan proponents put forward cannot operate in cash balance plans because: (1) cash balance plans are defined benefit plans; (2) defined benefit plans do not and cannot operate in this manner; and (3) if defined benefit plans were permitted to use this type of accrual pattern, they would violate the backloading provisions of the tax laws.

Under a typical cash balance plan with a uniform allocation formula, the annual accrual -- when expressed as a percentage of compensation -- decreases each year an employee grows older. There is no question about how the math works: if two employees of different ages have the same compensation and the same years of service, the amount of the younger employee's annual accrual will be greater than that of the older employee.

Cash balance plans cannot have it both ways: the formula used by a cash balance plan must comply with all applicable provisions of the Code, ERISA and the ADEA for defined benefit plans û one may not substitute defined contribution rules in a defined benefit plan. Employers may not offer for analysis different formulas for calculating accruals based upon the statutory standards to be satisfied (e.g., a frontloaded formula for purposes of the Code and a "savings plan" or other backloaded formula for purposes of the ADEA). Employees -- and the regulatory agencies -- must demand consistency in order to determine with some accuracy the benefit to be provided in a defined benefit plan, for that is the hallmark of such plans.

VI. WEARAWAY IS AN INDEFENSIBLE CESSATION OF BENEFIT ACCRUALS BECAUSE OF AGE IN A CASH BALANCE CONVERSION

A conversion to a cash balance plan from a traditional defined benefit plan can often include a so-called wearaway period. The wearaway is an impermissible reduction or cessation in benefit accruals based on age. A wearaway is not required nor necessary in a conversion, but can occur depending on the design of the plan conversion and the opening account balance chosen by the plan sponsor. The wearaway is the direct result of the fact that the benefits earned under the old plan formula must be guaranteed and cannot be reduced. Since an employee's accrued benefit in the traditional plan remains non-forfeitable at the time of conversion to a cash balance plan, the already-earned benefit is used, in essence, to offset any new benefits for a period of time under the new plan formula.

In determining benefits under the newly established cash balance plan, some employers have chosen to use a "greater of" formula to calculate benefits. "Under the 'greater of' formula, the benefits after the amendment are initially determined under the new formula based on a participant's service both before and after the amendment date and are then compared with a 'frozen' benefit equal to the participant's benefit as of the date of amendment. If the frozen benefit is greater than the new formula benefit...the participant does not actually earn additional benefits under the plan after the amendment, because the benefit the participant ultimately receives is attributable entirely to pre-amendment service. This phenomenon is sometimes called a 'wearaway.'"

Effectively, the employee's benefit is " worn away" through the mechanism of not providing additional benefits under the new formula until the new formula benefits catch up with the frozen benefit. While age is not the only element in determining wearaway, age is a critical element in determining the amount of the frozen benefit. Because the calculation of the wearaway is based directly on age, it violates the pension accrual laws.

In amending the ADEA in 1986, Congress made it unlawful for an employer to cause any "reduction" or "cessation" in the accruals of an employee in a defined benefit pension plan "because of age." *See* 29 USC § 623(i). While the original bills were designed to outlaw the common employer practice of discontinuing pension benefit accruals upon the attainment of the normal retirement age specified in the plan (generally age 65), the final legislative language contained no such limitation and indeed was crafted to more broadly prevent the reduction or cessation of benefit accrual based on age.

The amount of wearaway, if any, is determined by an impermissible reference to age. If the plan has two similarly situated employees, both with the same years of service and same salary -- with the only difference being that one is age 35 and one age 55 -- the older employee will experience the larger wearaway, assuming one exists in the conversion. While salary and service may also be a component in determining a wearaway, all else being equal, age is the determining factor of the amount of wearaway. To prove age discrimination, an employee need not prove that age was the sole factor for the employer's acts, but must show that age made a difference. *See Kralman v. Illinois Dept. of Veterans' Affairs*, 23 F.3d 150, 153 (7th Cir. 1994); *Green v. Safeway Stores, Inc.*, 98 F.3d 554, 557 (10th Cir. 1996).

Since the older employee -- given his closer proximity to normal retirement age -- will have accrued a larger benefit based on an annuity at age 65, an opening account balance based on the actuarial value of the traditional defined benefit plan will always be larger for the older employee, all other things being equal. But for their age difference, the wearaway for two similarly situated employees would be the same. The difference is purely based on age and the actuarial arithmetic -- the older the employee, and the closer to age 65, the bigger the opening account balance, and the longer the wearaway.

The following example illustrates the wearaway based on age. Assume two employees, age 35 and age 55, both with 15 years of credited service under a traditional defined benefit plan, both with a projected $1,000 monthly benefit at age 62.

IMPACT OF AGE & SERVICE ON WEAR-AWAY*

Attained Age	Credited Service	Monthly Pension Benefit at Age 60	Present Value of Pension Benefit	Cash Balance Account	Year one Wearaway Amount	Number of Years of Wearaway
35	15	1,000	$26,325	$20,041	$6,283	4
55	15	1,000	$87,582	$66,677	$20,905	8+

Source: *Poulin Associates, Inc.*

* Assumes Annual Earnings of $40,000; Normal Retirement Age of 62; Pay Credit of 5%; Salary Scale of 5%; Interest Rate of 6%; Discount Rate of 6%; Mortality According to GATT

All else being equal, the 55 year old employee will have a present value of pension benefit equal to $87,582, a cash balance account of $66,677 and a wearaway in the first year of $20,905. The older employee's benefit will effectively be frozen -- with no accruals û through the normal retirement age of 62, a wearaway period that lasts at least 8 years. The younger 35 year old employee will have a present value of pension benefit equal to $26,325, a cash balance account of $20,041 and a wearaway in the first year of $6,283. Further, the wearaway period for the younger employee will last only 4 years. The difference in the wearaway is based solely on age -- all else being equal. The older employee under this example will always have the longer wearaway.

VII. THE "WHIPSAW" LUMP SUM CALCULATION VIOLATES THE AGE PROHIBITIONS

The difference between the interest credit used by a cash balance plan and the discount rate required by section 417(e) of the Code to determine lump sums in a cash balance plan's formula also may discriminate against older workers solely because of their age. This so-called "whipsaw" occurs in the inherent plan formula itself, and thus can exist in a new plan or as a result of a conversion.

Many cash balance plans provide for an annual interest credit -- part of the accrued benefit -- that is higher than the required discount rate for determining lump sums for employees leaving employment. For example, the plan may provide for an annual interest credit of 7 percent, but the statutory discount rate, set in Code section 417(e), may be only 6 percent. As a result, every employee in such a plan will receive a larger lump sum upon termination than the amount in the hypothetical account. However, an older employee with the same exact salary and years of service under the plan will receive a smaller lump sum than a similarly situated younger employee.

For example, assume two otherwise equal employees, one age 30 and one age 60. Assume an accumulation rate of 7% and a discount rate of 6%, thereby creating a 1% whipsaw in the employee's favor. Under this example, the projected accumulation to retirement age (at 7%) for the 30 year old is $21,353. Discounted back (at 6%), the lump sum value at that age is $2,776. For a 60 year old, the accumulation would be $2,805, and the lump sum value only $2,096. The difference in the lump sum value that each otherwise identical employee would receive is based solely on age.

Age Discriminatory Effect of Whipsaw*

Age of Participant	Accumulation to Retirement Age	Lump Sum Value at Attained Age
30 60	$21,353 $2,805	$2,778 $2,096

Source: *Poulin Associates, Inc*.

* Assumes annual earnings of $40,000; Normal Retirement Age of 65; Pay Credit of 5%; Accumulation Rate of 7%; Discount Rate of 6%

Again, the difference in the lump sum benefit is based on the projection to normal retirement age required under a defined benefit plan. The one percent spread between the plan's (in this case) higher interest credit and the law's discount rate will increase the amount of the actual lump sum (compared to the hypothetical amount, which would be the same for the two employees) based on the number of years to normal retirement age. Since the number of years to normal retirement age will always be less for the older worker, there is in essence a non-uniform subsidy based solely on age -- with the younger worker always receiving a greater lump sum amount -- which thus reduces the benefit based on age. Again, this practice violates the prohibition on reducing benefit accruals based on age. (Of course, should the plan's interest rate be lower than the statutory discount rate, the lump sum would be greater for the older employee. However, the age restrictions in the statute do not prohibit such a result.)

VIII. ADEA DEFENSES ARE NOT AVAILABLE TO A CHARGE OF AGE DISCRIMINATION IN A CASH BALANCE PLAN

As demonstrated, age-based reductions in accruals -- both in the inherent cash balance formula and in the conversion from a traditional plan to a cash balance plan -- are illegal age discrimination in violation of the ADEA, the Code, and ERISA.

Employers have sought to defend these reductions in benefit accruals by citing to various defenses available under the ADEA. Their reliance on any of these defenses is inappropriate for a number of reasons. First, the ostensible "defenses" raised by employers to violations of the ADEA are *inapplicable to identical claims made under the corresponding sections of the Code or ERISA*. They therefore have no place in any debate (or even in litigation) relating to any reductions or cessation of accruals in cash balance plans and conversions. Second, the predictable, age-based reduction in accruals violates the explicit prohibitions of ADEA § 4(i). Congress allowed for *no exceptions or defenses* to the rule against accrual reductions in ADEA § 4(i) and its companion sections in the Code and ERISA when such reductions are based upon age. Third, these cases are clear examples of "disparate treatment" and therefore preclude the use of defenses that are applicable only to "age-neutral" practices.

XI. DISCLOSURE OF BENEFIT REDUCTION

Under current law, an employer converting to a cash balance plan must notify the plan participants as to the plan amendment. However, the employer need not describe how this amendment would impact the individual's benefits, nor how the new plan compares with benefits under the old plan formula. As a result, employees do not receive information as to the actual effect on their own plan benefits. A number of benefit consultants have noted that one of the "advantages" of conversions is the ability to "mask" benefit reductions. Many plans have chosen the route of ensuring technical compliance with the law, without regard to whether any useful information is actually communicated to employees. Obviously, the difficulty of sorting through the various plan formulas is a daunting task even to those who have sufficient information. For others, the impact cannot be discerned at all.

Plan participants who have contacted AARP generally all want to know one thing: How does this change affect me? AARP believes that it is essential that each affected employee be provided with a personalized statement that provides a comparison of the benefits under the old plan formula with the new plan formula. Benefits must be shown in a form that is comparable (e.g., lump sum vs. lump sum, not lump sum vs. a life annuity), and such information should be provided prior to the effective date of any plan change.

Depending on the facts and circumstances of the conversion, employers may violate ERISA's fiduciary rules (ERISA § 404) by failing to properly disclose information to plan participants, and indeed, as previously mentioned, by attempting to misrepresent the consequences of the conversion.

X. POLICY CONSIDERATIONS

Proponents of cash balance plans often boast of the potential benefits that cash balance plans have over traditional defined benefit plans. In particular, because cash balance plans are "frontloaded", shorter service employees may accrue larger benefits faster. In addition, because of the lump sum option, these amounts may be made more portable. Proponents often fail to note, however, that unless an employee satisfies the 5-year vesting period, an employee may get nothing under either a defined benefit or cash balance plan. In addition, a lump sum option could also be added to a traditional defined benefit plan if portability is the goal. (Indeed, even the increased portability may be of limited value if the lump sums are not saved for retirement. Currently about two-thirds of all lump sums are not rolled over into another retirement account.)

Some employers may desire a formula -- such as the cash balance formula -- that redistributes benefits from older and longer service employees to vested younger and shorter service employees. As a design for a new plan, or for new employees, some may prefer such an approach. However, the combination of both a guaranteed traditional defined benefit plan, plus a supplemental 401(k)-type plan, would be a better way to accomplish such a goal.

However, where there is a conversion from a traditional defined benefit formula to a cash balance formula (nearly all cash balance plans are the result of a conversion), there are additional consequences. Older longer service employees have been working under a plan that provided a different benefit structure -- the plan provided only a small amount of benefits in the early years, but if the employee stays longer, the plan will become more generous over time. For those employees who accepted that arrangement and are now entering the more generous years, the converted plan says, in effect, never mind.

While the pension law does not mandate that benefits will continue forever, neither does it permit plans to arbitrarily reduce benefits or terminate a plan without restrictions. For example, the Code clearly prevents cutbacks in accrued benefits. In addition, a defined benefit plan that terminates must pay both income and excise taxes on any reverted assets. Clearly the Code contemplates areas where benefit promises must be kept and employers may not unjustly enrich themselves from plan assets.

Yet the shift to a cash balance formula does just that. Employees who had been promised a backloaded pension format now find that the reverse is true. As a result, employees experience often dramatic reductions in expected benefits. Worse, they experience these reductions at a time when they are closer to retirement, having made retirement plans and employment decisions based on a different benefit pattern. Those who extol the potential virtues of the cash balance format often seem to ignore or have chosen to turn their backs on those adversely affected by the conversion. Proponents defend the practice by asserting -- incorrectly -- that the law permits it. While many companies have recognized the losses faced by older workers and have provided various remedies to their workforce -- such as permitting older workers to stay under the old plan formula -- proponents do not believe workers have any legal right to these future benefits, and that these inequities need not be addressed as a matter of public policy.

On the other hand, proponents would conveniently rather have cash balance plans treated more like defined contribution plans, with individuals receiving the amounts in their hypothetical accounts, rather than an amount based on an annuity at retirement. Yet, proponents acknowledge that cash balance plans are not defined contribution plans. The fact that the law requires defined benefit plans to be provided in the form of an annuity and that accruals are reduced on the basis of age in a cash balance formula is deemed a technicality to be circumvented, and if not, changed by law. However, proponents do not want cash balance plans treated too much like defined contribution plans, because they enjoy the funding flexibility and are unwilling to pay the income and excise taxes that a change from a defined benefit plan to a defined contribution plan normally entails.

Proponents cannot have it both ways. Proponents want cash balance plans treated as defined contribution plans for purposes of accrual rates, yet want cash balance plans treated as defined benefit plans for funding and tax purposes. Proponents side-step the adverse policy impact on older workers and offer up the law as a shield against addressing the reduction of future benefits for older workers, but raise policy concerns (and try to side-step the law) when the law governing defined benefit plans does not allow a plan to reduce benefit accruals based on age.

New cash balance plans, or cash balance plans for new employees, provide a third type of alternative to the current traditional defined benefit and defined contribution plan designs. The design of new cash balance plans -- a guaranteed employer-funded benefit, protected by the PBGC, expressed as a hypothetical individual account balance, that provides greater benefits to more mobile employees -- has different features than either a traditional defined benefit or defined contribution plan. But the problems for older workers caught in a conversion of a current defined benefit plan -- the loss of expected future benefits after having given up benefits in the early years, the reduced rate of benefit accruals, the potential for non-accruals during wearaway periods, and the often age discriminatory feature of a whipsawed lump sum -- outweighs any potential benefit of the cash balance design.

Indeed, the age discrimination laws were intended to prevent some of the very practices inherent in the cash balance plan design. The statute is very clear and specific that accruals may not be reduced because of age. The statute broadly prevents any potential age discriminatory features of plans, including any that might arise in the cash balance plan context. The statute was designed to address the harm (and, having played by the rules, the deep employee resentment) caused by cash balance conversions. If certain aspects of the cash balance alternative are to be preserved, then we must address the requirements of current law and policy to better protect older workers.

XI. PROPOPOSED REGULATORY SOLUTIONS TO IMPROPER CASH BALANCE PLAN DESIGNS

Cash balance plans can and should be brought into compliance with the age discrimination laws. To do so, their benefit accrual formulas have to be redesigned to increase -- within the confines of the backloading rules -- the accruals provided to older employees. The increased accruals could be derived from increases in the hypothetical allocation or the interest credit rates, thereby age-weighting the formula, or simply from the provision of additional accruals to older employees directly without disturbing the basic uniform hypothetical allocation or interest credit rate formula of the plan.

As one alternative, regulations could provide guidance to cash balance plan sponsors on the structure of age-weighted hypothetical allocation or interest credit rate formulas in the form of a safe harbor. Specifically, the cash balance plan's hypothetical allocation or interest credit rate would increase with age. The rate of increase would be the amount necessary to offset the decrease in benefit accruals that otherwise would result on account of an attainment of any age. However, the rate increase could not be so great as to cause the plan to be incapable of satisfying any of the backloading rules of section 411(b)(1)(A) through (C) of the Code. There may be different ways to structure such a safe harbor, and the Association would be open to further discussions.

Another option that has been put forward is to grandfather workers under the traditional defined benefit formula, or to give employees the choice of remaining under the old plan formula. While these options do not address the fundamental illegality of the cash balance plan design, they do address the adverse impact on older longer service workers that occur in a conversion to a cash balance plan. For that reason, a solution that includes a choice option -- preferably at the time of employee termination -- or "grandfather" option should also be pursued.

Other proposals have called for, in essence, splitting the plan into two parts: a pre-conversion benefit (part "A") and a post-conversion benefit (part "B"). The new benefit would then be based on an "A" plus "B" formula. Such an approach, while dealing with some issues, such as wearaway, does not deal with other issues, such as the violation of the age laws inherent in a cash balance plan. In addition, under such an approach, older longer-term employees are still faced with a significantly undervalued "A," since that part of the benefit is based on the least generous years under the old plan formula. In addition, the older worker, who is closer to the normal retirement age under the plan, will (absent any transition relief) also be facing the least generous time under the new cash balance formula. Some have suggested -- as one option to improve the "A" plus "B" format -- a further indexation of the benefit under "A" (e.g., for wage increases) to ensure a more consistent and fairer value under the defined benefit format. While such an approach recognizes, at least in part, the unfairness to the older worker of a cash balance plan conversion, it is generally not as generous as a "grandfather" or "choice" option.

XV. CONCLUSION

AARP appreciates the fact that this committee has begun the review of issues raised by cash balance plans themselves and the conversion of traditional plans to cash balance plans. We look forward to assisting this committee and others to ensure that these plans fully comply with the requirements of current law, and in particular the prohibitions against benefit reductions based on age. We also will continue to join efforts to ensure that the pension system delivers more adequate and secure benefits for current and future retirees.