STATEMENT OF KAREN W. FERGUSON

Mr. Chairman, Members of the Committee, I am Karen Ferguson, Director of the Pension Rights Center. The Center is the nation's only consumer organization devoted solely to protecting the pension interests of American workers, retirees and their families. Thank you for the invitation to appear here today to discuss the problems created by cash balance conversions, and proposed solutions to those problems.

PROBLEMS CREATED BY CASH BALANCE CONVERSIONS

To put today's hearing in perspective, I would like to start by noting that never in the 24-year history of the Pension Rights Center have we seen such an outpouring of employee anger, frustration and bewilderment as that occasioned by the conversion of traditional defined benefit plans to cash balance arrangements. Although the largest proportion of complaints have come from employees of Fortune 100 companies, such as IBM, Bell Atlantic, Citibank, SBC, and AT&T, we have also heard from employees in smaller organizations, including a symphony orchestra, a for-profit hospital, a nonprofit educational corporation, and a popular restaurant chain.

These employees are outraged because they thought they had a deal: If they did their part by working loyally for long years for their employer, they would get a good pension that, together with their Social Security and savings, would make it possible for them to maintain their standard of living in retirement. They were aware that their Pensions were not worth much in their early years of work, but had been assured that their plans would "pay off" as they neared retirement age. Typically, their plans had been designed so that 50 percent of their pension would be earned in their last 10 years of work. Many of these employees are highly skilled professionals who could easily have found other employment, but chose to stay because of the promised pensions.

The employees' expectations were reasonable. Their plans calculated their pensions by multiplying all of their years worked by a percentage of their pay in their final years of employment, and also typically included a subsidized early retirement provision that would allow them to leave the company well before age 65 on a full (or almost full) pension. Instead, as the suit of a cash balance conversion, they will get pensions, which, in many cases, are worth hundreds of thousands of dollars less.

It is important to note that the employees' understanding of "the dear" was shared equally by their employers. The companies funded their pension plans with the expectation that a significant portion of their workforce would retire at a time when their salaries were much higher, and with an early retirement subsidy. To our knowledge all of these plans were funded to assure that they would be able to pay these "projected" benefit obligations.

As employees see it, their employers reneged on the deal by converting their plans to cash balance formulas. In some instances the conversion occurred shortly a takeover or the advent of a new management team, but, whatever the circumstance -- and whatever the rhetoric accompanying the change -- the result was an immediate and substantial saving on pension costs that significantly boosted their companies' bottom line. Put simply, the employees feet betrayed.

Employers defend their actions by contending that cash balance plans are better designed for today's highly mobile workforce, provide higher benefits at earlier age benefit plans, and are portable and easier to understand by employees who are accustomed to the simplicity of individual savings accounts. Employers contend that with the booming economy, cash balance plans are necessary to attract new workers. They also say that with a shrinking workforce, they no longer need to offer subsidized early retirement benefits -- the most important feature of traditional plans for many large companies -- because they do not want to encourage older workers to leave.

In fact, these claims do not pass muster. Certainly, career-average formulas may be better for many younger workers, but adoption of these formulas need not be at the expense of mid-career and older workers. To our knowledge, all of the companies that have switched to cash balance plans had pre-funded their plans in anticipation of paying larger benefits to these workers.

In addition, overfimded traditional plans can easily provide portability and increased accruals to assure that younger employees get meaningful benefits. With millions, and in many cases billions, of dollars in pension surpluses, virtually all of these employers could easily provide significant enhancements to their benefit formulas for younger workers - and allow terminating employees to take lump sums. Moreover, traditional plans could be made to look more like individual account arrangements simply by disclosing the present lump sum value of benefits to employees.

In implementing cash balance plans, it is employers, not the employees, who get the benefit. They get the simplicity, flexibility, and low costs of an individual account plan, while at the same time providing employees extremely small contributions that in most cases are fully paid for by the surplus from the pre-existing plan and stock market returns that far exceed the meager amounts they have promised.

Companies argue that employees are better off under these plans than if they simply terminated and set up 401 (k) plans because the employer takes the risk. But, we ask, what risk? If the stock market plummets, employers can simply reduce their promised contribution under the cash balance plan, or terminate the plan altogether.

We have already begun to see companies that converted to cash balance plans reducing their contributions. According to employees, MCI, which converted to a cash balance plan a number of years ago has now eliminated all of its contributions to the plan, and only provides interest credits. The company explained that, instead, it was improving its 401(k) plan. Not mentioned is the fact that the improvements to the 401(k) will benefit only those employees who can afford to voluntarily contribute to the plan.

As for the benefits of cash balance plans for young, mobile workers, almost all cash balance plans have five-year vesting. Yet according to the Labor Department, the median job tenure for workers aged 25 to 34 is just 2.7 years and many young people will hold as many as nine jobs by the time they're 32. A December 16, 1999 Wall Street Journal article notes that this rapid turnover combines with five-year vesting to prevent countless younger employees from gaffiing any benefit at all from cash balance plans. The article points out that 57 percent of employees in the MCI cash balance plan left before they were vested.

In addition, those younger workers who stay until they are vested, will get extremely small amounts since cash balance plans are typically weighted for age, with young employees receiving extremely small pay credits.

Then there is the employers' claim that they need to eliminate subsidized early retirement benefits in order to encourage employees to remain with the company. This is also suspect. The reports we receive from rnid-career and older employees working for companies that have converted to cash balance plans suggest that employers have little interest in retaining older employees. Rather, the companies no longer feel that they have to provide early retirement packages to "ease" the employees out. After cash balance conversions, some older employee earn so little, if anything, in future benefits, that they conclude that it is no longer worth their while to stay. Those who can find other jobs, leave. If employers really wanted to retain older employees, they could use pension surpluses to offer a variety of incentives, among them, increased benefit levels and cost of living adjustments when they retire.

Finally, although employers argue that cash balance plans are superior to 401(k) plans, there is a very real possibility that these are just "way stations," on the road to total reliance on individual savings plans. If true, this would be very disconcerting since government figures show that 401(k)s continue to be used primarily for non-retirement purposes, and by better-off employees. According to the 1998 Survey of Consumer Finances, the median household account balance for 401(k)s was only $15,000.

PROPOSED SOLUTIONS TO CASH BALANCE CONVERSION PROBLEMS

First, we strongly believe that no legislative "solution" to cash balance conversion problems should interfere with litigation and age discrimination complaints that have already been filed. Employers knew full well that their actions were unlawful, and simply counted on the fact that they were "too big to fail." Since all of the plans that have been challenged have ample surplus assets, they can readily settle these complaints, before the agencies and courts rule, by offering current employees the choice to go back under the prior plan, and restoring pension losses to those employees who left the plan as a result of the conversion.

Second, we believe that any legislative proposals should include the following three components:

- **An option for employers to offer their employees a choice between their pre-existing plan and the cash balance plan (or the "better of" the two plans);**

- **Alternative provisions that will assure that conversions meet minimum requirements designed to fulfill the reasonable expectations of employees and employers;**

- **Clarification that conversions that fail to provide "choice" or to satisfy the minimum requirements will be considered to be plan terminations, subjecting any reversion to full excise taxes.**

I. Incentives to Encourage Employers to Choose Choice.

In our view, any legislative proposal should provide an option to employers to "do the right thing," namely, offer employees the right to choose to stay under their old plan (and, ideally, require that the choice not be made until retirement age), or give them the better of the benefits under the old and the new plans. Fortunately, this is what a growing number of employers are already doing. These "best practices" should be encouraged.

- **An Alternative to Fulfill "Reasonable Expectations" of Employees and Employers.**

From the vantage point most of the affected employees, "choice" or a "better-of " formula are the only acceptable options. However, in the interest of resolving this extremely contentious issue expeditiously, before more employees are hurt, we propose a compromise alternative.

This fall-back approach would assure that employees would receive the equivalent of the full benefits they had counted on getting under the old formula *for the work they have performed as of the date of the cash balance conversion,* to the extent that the plan has sufficient funds at the time of the conversion to pay for these benefits, plus full benefits under the cash balance plan for future years of work.

This approach reflects the fact that, as noted above, until the advent of cash balance conversions, mid-career and older employees in most traditional defined benefit plans reasonably anticipated that if their company remained profitable, and if they kept working, and if the pension plan had ample funds to pay promised benefits, that they would be paid unreduced (or substantially unreduced) benefits at early retirement age, if they met specified age and service requirements, and that they would receive benefits that would be calculated on the basis of their earnings at the time they left the company. At the same time, it incorporates the employers' expectations that they could change the rules at any time for any work performed in the future. This alternative proposal is extremely simple in concept, but complicated to explain. It has four parts.

Part one assures that opening account balances in cash balance plans will be calculated fairly. It proposes using a single statutorily prescribed interest rate to convert the employees' annuities under the old plan into "hypothetical" opening account balances.[(1)]

Part two of the proposal addresses the expectation of many mid-career and older employees that they will receive subsidized benefits at early retirement age (or after a specified period of service).

Under current rules, if a cash balance conversion occurs before employees meet the requirements of a subsidized early retirement pension, and the employees subsequently satisfy those requirements, the employees' lifetime monthly pensions must be "bumped up" to reflect the pro rata share of the subsidy that the employees have earned as of the date of the conversion. If, however, the employees' benefits are paid as lump sums, the subsidy can be forfeited. This can result in the loss of up to 60 percent of the value of their pensions.

The proposal addresses this problem by building on a long-standing tax code principle designed to deter employers from amending plans for the purpose of increasing the amount of surplus assets in their plans that could potentially revert to them. It would require the "vesting" of a pro rata. share of the early retirement subsidy on the date of the conversion, to the extent that there are sufficient funds in the plan to pay these amounts. These amounts would then be added to the "hypothetical" cash balance accounts. (2)

Part three of our proposal addresses the employees' expectation that they would receive pensions based on their earnings at the time they left the company. It has three stages:

- In stage one, the employers would be required to calculate the employees' hypothetical opening account balances on the basis of their pay at the time of the conversion.
- At stage two, when the employee retired, there would be a recalculation, based on any increase in pay (for the service performed at the time of the conversion).
- The third stage would entail retroactively crediting contributions (and compounding interest) on the difference between the opening account balance and the balance as recalculated at retirement. (3)

III. **Clarification that the full reversion excise tax applies, if these rules are not followed**.

If employers opt not to allow their mid-career and older employees to stay in their old plan until retirement age, and/or provide them with roughly equivalent benefits under the cash balance plan, the pre-existing plan has plainly terminated with respect to these employees, and the full 50 percent reversion excise tax should be imposed on any surplus assets.

There are, of course, other legislative measures that should be considered. They include proposals to address problems of inadequate disclosure and, most important, the untenable conflict of interest situation created by Financial Accounting Standard Board's Rule 87 -- which we think poses the most serious threat to date to the future of the defined benefit system. I would be pleased to discuss this all-important issue in the question period. Thank you.

1 it is necessary to do the "hypothetical" conversion because all pay credits and interest under the new cash balance plan will be added to this amount. However, the amount is only "hypothetical" because the benefits under the old plan will be paid out as an annuity if this was the normal form of benefits under the plan (or the form selected by the employee).

2 This would provide a financial incentive to employers to offer their mid-career and older employees the choice of staying under the old plan since, by giving the pro-rata share of the subsidy to all employees (not just to those who later meet the age and service requirements), would increase costs above those originally projected for the subsidy.

3 To assure that sufficient funds would be available, plans would be required to spin off the amounts projected to be needed for this purpose at the time of the conversion. These funds could either be added to the trust being used to pay participants who retired before the conversion, or segregated in a separate trust. Any shortfalls would be made up by the employers; any excess would be allocated among post-conversion participants.