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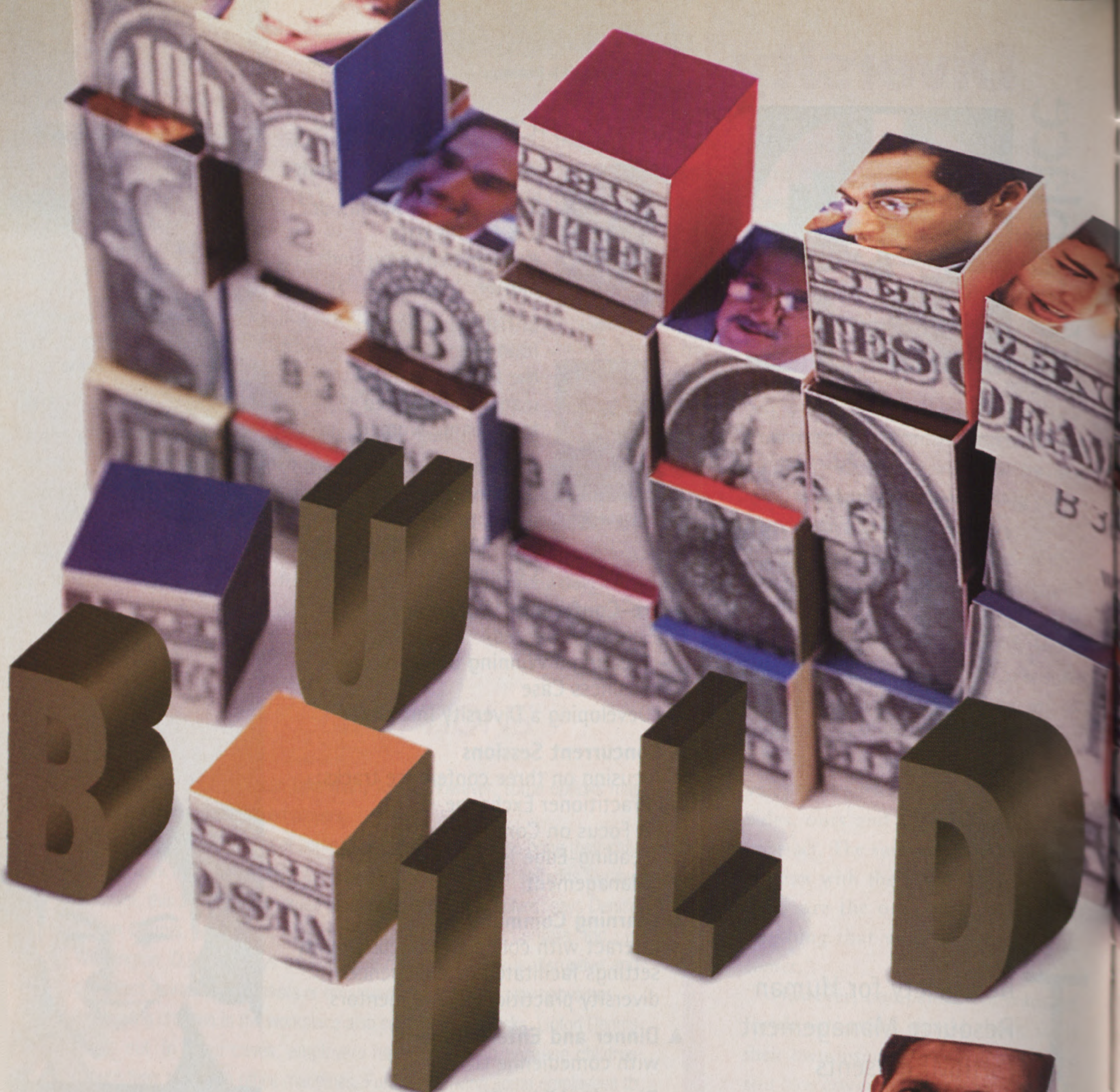

Think you need a 'cash balance' or other hybrid pension plan? Here's how to decide.

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A Better Retirement Plan

By R. Evan Inglis and Steven G. Vernon

Retirement is one hot topic today—mainly because the huge baby boomer generation is beginning to take it seriously. This interest—combined with a long bull market in stocks and a strained Social Security system—is whipping up a frenzied storm of activity about retirement plans. Employers, one of our society's key providers of retirement income, are right in the eye of the storm.

The diverse needs of the workforce—and frequent mergers and acquisitions that spur the need to coordinate benefit and compensation programs—also are forcing employers to examine whether their retirement plans are adequate. Generally, neither traditional defined benefit (DB) plans nor the popular 401(k) or

Pension Plan Types

• Traditional pension plan. Otherwise known as a defined benefit (DB) plan; communicates benefits as annuity amounts and pays annuity benefits; benefits accrue with each year of service and are often a percentage of final average earnings; usually a significant jump in value of benefits at about age 55 when participant becomes eligible for retirement; employer controls investments.

• Cash-balance plan. Technically (according to the IRS) a DB plan; communicates benefits as an account balance and usually pays both lump sums and annuity benefits; hypothetical contributions are made to each participant's account, and the accounts earn a predetermined rate of interest; employer almost always controls investments.

• Pension equity plan (PEP). A type of DB plan; communicates benefits as a lump-sum amount with a multiple of earnings based on service (e.g. 10 years of service might equal final earnings and 20 years of service might equal twice final average earnings, both paid as a lump sum); usually pays both lump sums and annuities; employer controls investments.

• Defined contribution (DC) only. Communicates benefits as an account balance; pays benefits as lump sum but may offer annuities; contributions made to an account balance, which is credited with the actual earnings on the funds invested; employer or employees may control investments.

Table 1 *Distribution of Fortune 100 Pension Plans*

Traditional pension plan*	68%
Cash-balance plan*	16
Pension equity plan*	6
Defined contribution only	10

**Most of these firms also offer 401(k)s*

Source: Watson Wyatt Worldwide.

similar deferred compensation (DC) plans will meet all of the desired objectives on their own.

As a result, employers are examining—and changing—their retirement programs at a record pace, as well as making greater efforts to offer pension benefits that are both understandable and accessible to employees. Many of the largest U.S. corporations have installed nontraditional retirement programs for their employees (Table 1, above). Cash balance, pension equity and other "hybrid" designs often are replacing traditional defined benefit plans (see box above for explanation of plan types).

So, how do you determine whether your current plan is meeting your needs or choose a new retirement plan to meet new objectives? A systematic process such as the "building blocks" approach described here can help you get an initial read.

The Four-Step Approach

Redesigning a retirement program typically involves four major steps:

- Setting objectives for the plan in the context of overall business and HR objectives.
- Deciding on the basic plan that best meets objectives (the "ideal" plan).
- Creating transitional provisions (grandfathering provisions and the like).
- Implementing and communicating the new plan.

Steps one and two are especially crucial because steps three and four—as well as the success of the whole program for both employers and employees—depend upon choosing the right plan design. While communication is critical to the success of the chosen plan, the design of the plan needs to establish the right message.

Determining the best basic plan for your workforce requires weighing the employer's objectives against the advantages and disadvantages of different types of retirement plans. For a number of reasons, this link between objectives and plan design is often difficult to find. Imprecise reasoning may go something like this: "The business world is changing, and our defined benefit plan doesn't meet our needs anymore. But a pure DC approach isn't right; therefore, we need a 'hybrid' plan. So, let's put in a cash balance plan."

This approach makes it difficult to associate advantages and disadvantages with different types of plans. Any retirement plan can be fundamentally changed—without changing the "type" of plan—by tweaking and changing certain provisions.

For example, allowing lump-sum payments can fundamentally change a traditional DB pension plan. You also can easily change a DC plan by not permitting lump-sum payments. In short, there is no bright line that distinguishes a particular type of retirement plan and the objectives it will meet from other types of plans.

In addition to the fuzzy relationship between objectives and types of retirement plans, other potential problems can emerge:

- People have preconceived ideas about DB and DC plans, cash-balance plans, pension-equity plans and so on. These perceptions can become barriers to agreement on the right plan design.
- Setting objectives is difficult. What are the possible objectives to consider? Which objectives will be difficult to achieve in the same plan?

At the end of the process, it is often difficult to see the link between objectives and plan design. Why was this particular cash-balance design considered best for the organization? It is not necessarily clear how any particular objective manifests itself in the plan. Often employers, and even their consultants, don't really understand the link between their objectives and the plan design.

So, moving from setting objectives to selecting the right type of plan can be difficult without a systematic process.

Retirement Plan Building Blocks

With the "building blocks" approach, your first step is to throw out the concepts of "defined benefit" and "defined contribution." Instead, think of any plan in terms of the 10 components shown in Table 2, below.

Each building block can be viewed as a scale, from left to right. Designing plans with building blocks involves choosing which end of the scale best fits organizational objectives. By determining on which end of the scale they want to be for each building block, plan designers will know what kind of pension plan meets their needs. Just as important, they'll know why.

To provide perspective, the blocks are grouped into three categories. The first category has three blocks related to plan structure. These blocks affect how benefits are defined and paid and when employees are eligible.

The next category consists of three blocks related to value allocation. These blocks relate to questions such as how retirement plan dollars will be divvied up between older employees and younger employees and between high performers and non-high performers.

The four building blocks in the third category relate to financial and investment structure. Fundamental questions here include: Does the employer or employee make investment decisions? Does the employer or employee benefit from favorable asset returns? Do employees make contributions? Should employer contributions and employee benefits be increased or decreased based on the financial performance of the company?

Each building block has advantages associated with each end of the scale, as shown for the Investment Risk building block (Table 3, page 94). (A useful guide to plan provisions that satisfy Internal Revenue Code requirements is available on the IRS web site at www.irs.ustreas.gov/prod/bus_info/ep/index.html.) Using the building blocks, you design a pension plan by comparing the advantages at each end of the scale and choosing the most appropriate advantages for your company.

This process has several key advantages over the traditional plan selection process.

- No preconceived ideas. Terms such as DB and DC never enter into the discussion, thereby mitigating the effect of preconceived ideas.
- A clear link between objectives

Table 2

Retirement Plan Building Blocks

Plan Structure Building Blocks

Benefit Formula ➤➤ Account Balance

Annuity Benefit ➤➤ Lump Sum Benefit

Target Retirement Ages ➤➤ No Target Retirement Ages

Value Allocation Building Blocks

Low Value for Younger Employees ➤➤ High Value for Younger Employees

High Value for Older Employees ➤➤ Low Value for Older Employees

Not Related to Individual Performance ➤➤ Related to Individual Performance

Financial and Investment Structure Building Blocks

Employer Investment Control ➤➤ Employee Investment Control

Employer Investment Risk ➤➤ Employee Investment Risk

No Employee Contributions ➤➤ Employee Contributions

Not Related to Company Performance ➤➤ Related to Company Performance and plan design. Objectives are clearly spelled out in the form of the advantages associated with either end of the scales. It is easy to see and understand a direct link between objectives and plan design.

- Ease in tackling the job. By looking at individual components, a plan-design team can understand how each component can help achieve objectives.
- Ease in setting objectives. Essentially, any retirement program objective is connected with one or more building blocks. Thus a thorough discussion and decision about each building block will result in setting objectives and designing the plan all at once. One immediately sees the trade-offs that are necessary. For example, looking at the Investment Risk example, one can see immediately that it will be difficult to achieve stable costs and to shield employees from poor investment results in the same plan.

Table 3

Investment Risk Building Block

Examining the advantages of either end of the scale reveals pension benefit objectives that can be met.

Advantages of Employer Investment Risk

- Employee is shielded from a bear market just before retirement.
- Employer gets lower contributions if favorable investment experience.
- Employer contributions can be adjusted based on financial situation.
- Benefits are insured by the Pension Benefit Guaranty Corp. (PBGC).

Advantages of Employee Investment Risk

- Employees may become more engaged in planning for retirement.
- Employees get higher benefits if favorable investment experience.
- Easier for employer to budget; costs are more stable.
- Employer is shielded from increasing contributions due to poor results.
- No PBGC premiums.

Building a Plan

The following demonstrates how a typical discussion of building blocks might proceed.

Two consultants, Tom and Sara, meet with officials from Something.com, a traditional manufacturer with a 401(k) plan and a traditional DB plan. Now, the company is selling its products on the Internet, and management believes that its current plan may not be meeting the company's needs. Something.com has six people at the meeting: the vice president of human resources, the compensation and benefits manager, two senior benefits administrators, the CFO and the assistant treasurer.

Together, the group will go through the 10 building blocks to design Something.com's ideal retirement plan. While the exercise is straightforward, the consultants play key roles in explaining some of the intricacies of each element.

Tom explains that it will be most straightforward to go through the discussion with the assumption that Something.com's 401(k) plan will exist as is and to focus the discussion on a possible replacement for the DB plan.

"We could consider the entire retirement program as a whole," Tom says, "but we usually find the discussion is easier if we assume that the 401(k) will be there. It's a good assumption because you won't want to give up the tax benefits for employees. We may end up talking about changes to the 401(k) plan depending on how the rest of the discussion goes."

"One more rule," adds Sara. "We should conduct our discussion without using the terms 'defined benefit' and 'defined contribution.' "

Sara explains that she will record the discussion on a scorecard for later reference. She hands one to each participant so they can follow along. The scorecards show each building block and list three to six advantages at each end of the scale for each element.

The group starts with the Benefit Formula vs. Account Balance building block. Several advantages are associated with each side of the scale, but the HR staff favors an account-balance approach because employees will better understand the value of their benefits. The two executives from finance want a benefit formula because they'll be able to design the plan to provide a specific target of income level at retirement.

The HR VP expresses frustration that the group cannot agree on one side of the scale. Sara replies that this may not be a problem. "Some of the building blocks are not either/or choices. This is one where some plan designs will allow you to compromise between benefit formula and account balance. Let's call it a tie for now and come back to it again before we finish." They agree to move on.

The next building block is Annuity vs. Lump Sum. Sara points out that this is another building block that does not require choosing one extreme or the other. The group quickly agrees that they want to offer the efficiency of annuities (they don't pay too much to those who don't live long, but don't pay too little to those who live to be 100) and the easy administration of lump sums (paying retirees immediately reduces the administrative burden). They will work out the details later but the group's objectives of minimizing administration through lump sums and maximizing benefits through annuities may lead them to offering a choice of lump sums or annuities as long as the lump sum is under a certain dollar amount, perhaps $50,000.

The group moves on to Target Retirement Ages vs. No Target Retirement Ages.

Tom explains, "In your current plan, people are eligible to retire at age 55 with 10 years of service. Because of the way the reduction in benefit works, there is a significant increase in the value of the benefit when a participant reaches that age. The value of the benefit goes up even though the amount is reduced because payments will start earlier and be paid over a longer period. Age 55 is a target retirement age. You have another target age at 60 when people can retire with an unreduced benefit."

None of the group has ever really understood the early-retirement reductions in their plan, and they believe most participants don't understand them either. They agree that their ideal plan should not have target retirement ages. This means that the new plan will not provide benefits that increase in value based on a participant reaching a certain age (or age/service combination). Participants will receive benefits on the same terms regardless of their age.

Now the group is feeling comfortable with the process and can move on to the next element. Sara explains that Something.com will want to spend its retirement program dollars as effectively as possible to meet its HR objectives.

"The next set of building blocks all relate to who receives the retirement dollars you provide," she says. "The Value for Young Employees and Value for Old Employees elements will help us decide whether you want to target relatively more dollars to older or younger employees."

The ensuing discussion makes it obvious that Something.com needs to retain people longer and that the company needs to attract mid-career hires. "We have plenty of young graduates knocking on the door," says the manager of compensation and benefits. The group chooses lower value for younger employees and higher value for older employees.

Moving on to the Individual Performance building block, the group decides that the plan should not be related to individual performance.

Now, the finance executives are getting revved up; it's time to talk about the financial and investment aspects of the plan. The first of these building blocks is Investment Control. All agree that Something.com should maintain control of the investments because experience has shown that its 401(k) participants, on average, do not make good investment decisions.

In addition, Tom points out that most of the advantages of giving investment control to employees, including engaging them in planning for retirement, are already achieved by the 401(k) plan. The group nods. "OK, employer investment control then," says Sara, noting this on her scorecard.

After a short discussion of Investment Risk, it becomes obvious that the entire group also believes that Something.com should assume the investment risk.

"We have a longer time horizon and can ride out a bad market better than an individual participant," points out the CFO. The finance executives like the fact that taking on the investment risk should give them some flexibility in making contributions, which they view as more important than stable, predictable contributions.

The group quickly agrees on the last two items, choosing No Employee Contributions and Not Related to Company Performance.

The first element is taken up again and, in the end, a consensus is reached that the group would like to lean toward an account-balance approach. "Now the magic of the building blocks process is truly revealed," says Tom. "Not only have you defined your ideal plan, you've defined your retirement program objectives as well."

The group defined its objectives as follows. Something.com wants

- Employees to understand the value of their benefits so they appreciate the plan; this leads to more loyal employees.
- To encourage employees to stay with the company for 15 years to 30 years.
- To attract mid-career hires.
- Retirement dollars to be used for retirement only, but will sacrifice this to a certain extent to ease administration.
- Participants to get the highest benefits possible for the company's retirement dollars.
- Employees to participate in planning and providing for retirement—an objective that will be largely accomplished through the 401(k) plan.

With these points in mind, Sara describes the two plan designs that will meet these objectives:

- A cash-balance plan with age-weighted contributions.
- A pension-equity plan (PEP).

"To decide between a cash-balance plan and a PEP, we need to talk into more detail about the account-balance approach of the cash-balance plan and the lump-sum approach of the PEP plan," says Tom. "We'll save that discussion for our next meeting. That discussion will give us a chance to explore the details of these two plan design types.

"We've accomplished a lot today. We've defined the objectives of your retirement program and narrowed the entire universe of plans to two specific plan designs. There's lots of hard work ahead—we need to decide how much you want to spend on the plan and how to transition from your current plan. But that'll be a lot easier now that we know where we want to end up."

Once the ideal plan is selected, difficult decisions still remain. The level of the benefits in the plan needs to be set so that the desired cost level is achieved. Adjustments to the plan design need to be made after considering tax law issues, such as whether every aspect of the plan is allowed and whether nondiscrimination tests will be met. Transition issues for participants who might lose out in the new plan design must be considered.

While these are important and difficult issues, they are easier to resolve when a solid "ideal" plan has agreement from all concerned. HR

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