Covering the Uncovered

Common Ground Recommendations to Expand Retirement Savings for American Workers

Working Report

Conversation on Coverage

Supporters

The Pension Rights Center gratefully acknowledges the following supporters of the Conversation on Coverage:

The Ford Foundation

The Charles Stewart Mott Foundation

The Annie E. Casey Foundation

Sponsoring Organizations

AARP

AFL-CIO

ASPPA Pension Education and Research Foundation

MetLife

Co-Sponsoring Organizations

American Academy of Actuaries

American Benefits Institute

Fidelity Investments

Motorola

TIAA-CREF Institute

Urban Institute

Working Group One Report

Report on the Conversations and Recommendations of Working Group I

Working Group's Assignment

Answer This Question:
How do we increase coverage by encouraging incentives for both traditional and new forms of defined benefit plans?

Co-Chairs:

Melissa Kahn
Norman Stein

Working Group Members:

Phyllis Borzi
Ellen Bruce
David Certner
Charles Cole
Patricia Dilley
Lynn Dudley
Ron Gebhardtsbauer
Deene Goodlaw
Brian Graff
Nell Hennessy
Mike Johnston
Judy Mazo
Shaun O'Brien
Bob Patrician

Executive Summary

The Working Group held a series of meetings between May and November of 2003 to discuss ways to increase the number of workers in the workforce who work at companies that offer a defined benefit plan. Such plans typically promise a benefit that provides a guaranteed stream of income for life after retirement. Defined benefit plans are funded by the employer and the promised benefit level does not depend on the actual performance of the plan assets. An increase in workers covered by a defined benefit plan can be achieved both by encouraging employers that already sponsor defined benefit plans to extend coverage to more of their workers and by efforts or policies that prompt more employers to offer a defined benefit plan.

Defined benefit plans have several advantages for employees. Since employers fund the plan, employees do not have to determine how much they need to save to receive a defined benefit at retirement. Nor do they need to make contributions to receive the benefit.[1] The employer, and not the employee, bears the market risk associated with investment performance. The employer, and not the employee, decides how to invest the income and reallocate assets over time. And, to the extent that retirees take their distribution in the form of a lifetime annuity, they are relieved of the task of creating a budget for drawing down over time the funds in a lump sum, as well as deciding how to manage and invest the funds after retirement age.[2] Further, retirement income provided by defined benefit plans is federally guaranteed[3] with coverage provided by the federal Pension Benefit Guaranty Corporation.

The members of the Working Group reviewed recent proposals for new types of defined benefit plans that were designed to appeal to employers who currently do not offer a defined benefit plan (See Appendices A and B). They looked at traditional plan designs and new types of plan designs that contain features of defined benefit plans. After reviewing those suggested approaches, the Working Group put together the basic outlines of two new proposals – the Guaranteed Account Plan (GAP) and the Plain Old Pension Plan (POPP) – aimed at employers who may be interested in sponsoring a defined benefit plan but who are also wary of the liabilities and burdens associated with traditional pension plans.

Guaranteed Account Plan. The Working Group generally agreed on the key design features of this plan, listed below:

- The proposed plan is a new kind of hybrid plan that takes the existing money purchase plan and adds a guaranteed account balance. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker.
- The account of each participant is credited with an annual employer contribution.
- Benefits are funded by the employer, based on standardized and conservative funding assumptions; employees could also elect to contribute on a pretax basis.
- The plan guarantees the annual rate of return on participants' account balances.

> "I think the Conversation has really been quite extraordinary . . . it has brought together a broad array of interests. Really most every expert that I've come across in my years of work in this business appears to be involved in this common endeavor."
>
> Representative Earl Pomeroy (D-ND) from his address at the Conversation's National Policy Forum, July 22, 2004.

- The employer invests the plan assets so employees do not self-direct the investments.
- The plan offers an annuity as the automatic payment option, but participants may also be offered as an alternative a lump sum equal to the amount credited to the participant's account.

With this basic design, GAP transfers from the employee to the employer the risks associated with choosing appropriate investments, as well as the financial market risk of how well investments perform.

The Plain Old Pension Plan. The Working Group generally agreed on the key design features of this proposed plan, which are listed below:

- The plan is a simple, easy-to-understand traditional defined benefit plan that provides a modest basic benefit to allay employer concerns about funding the plan.
- The final basic benefit is based on a percentage (as low as one percent) of an employee's career average pay multiplied by the number of years of service.
- The plan would allow employers to fund bonus benefits in any given year or years that would raise the final benefit without having the bonus benefits become part of the permanent benefit structure.
- The plan would permit, but not require, a generous past service credit that would be attractive to small business owners.
- All benefits from the plan would be paid in the form of an annuity only.

Tax Credit Provisions. The Working Group also supported a number of tax credit provisions that would encourage employers to adopt and maintain a defined benefit plan, as well as to expand the number of workers covered by a defined benefit pension plan.

Some of the proposals adopted may require changes in public policy and some may be pursued through demonstration projects. This will be determined in the third stage of the Conversation on Coverage.

The Mission

The mission of Working Group I was to develop proposals that would expand the aggregate number of workers covered by a plan that offers a defined benefit. A defined benefit plan is a retirement plan offered by an employer who is legally obligated to fund the plan's promise to provide a monthly retirement benefit to each eligible employee and surviving spouse based on years of service and earnings. (See plan type definitions pages 18-20 for more information.) The group generally agreed that expanded coverage would include providing coverage to employees at firms that previously did not have a plan with defined benefits, as well as extending coverage to groups of employees at firms with a defined benefit plan that were not previously covered by the plan.

The Working Group also sought to find ways to help prevent further erosion of the number of workers currently covered by defined benefit plans. To support this goal, the group generally agreed to support proposals that would encourage employers who currently sponsor defined benefit plans to continue sponsoring such plans. The group also generally agreed it should not support proposals that might discourage employers who sponsor defined benefit plans from continuing to do so. This approach was seen as being similar to physicians who take the Hippocratic Oath: 'First, do no harm.'

Background

The defined benefit plan is no longer the preeminent and preferred method of providing retirement income for employees. The plan's dominant position has been eroded in a single generation, as the proportion of the private sector workforce covered by a defined benefit plan was cut in half from 38 percent in 1978 to 19 percent in 1998.[4]

Meanwhile the proportion of workers with a defined contribution plan as their primary retirement plan rose sharply over the same period from seven percent to 27 percent, making the defined contribution plan the dominant type of plan in the workforce.[5] A defined contribution plan is an employer-sponsored retirement savings plan that accumulates assets from employee contributions and/or employer contributions. There is no specific promised benefit at retirement and the investment risk falls on each individual employee. In the 401(k) and 403(b) models now predominant (both defined contribution plans) employees determine how much they should save and often choose how to invest their retirement savings. (See definitions on pages 18-

20.) The employee's retirement income is based on the contributions made into the account and the accumulated earnings at retirement.

Federal pension data illustrate the extent of the decline in defined benefit plans and employees covered by such plans. The number of workers covered has declined and the number of plans has fallen sharply. According to a Congressional Research Service paper, the number of workers covered fell from 29.3 million in 1983 to just under 23 million in 1998. [6] At the same time, the number of plans fell from 175,000 to 56,400, with most of the loss of plans occurring among small businesses (those with 99 or fewer workers). The proportional decline has been greatest among small plans. Between 1983 and 1998, for example, the number of workers in small plans fell by a disturbing 65 percent, from 1.86 million to 648,000. That represented a loss of more than 1.21 million workers. For the biggest firms, however, there was an even greater decline, with only 5.8 million of workers enrolled in defined benefit plans. In 1983, the number of active participants in defined benefit plans at large companies stood at 28.1 million. By 1998, it had declined 21 percent to 22.3 million.[7]

The Pension Benefit Guaranty Corporation provides estimates on the number of plans and the number of participants and beneficiaries of those plans based on premiums that are paid to the agency. PBGC reports that in 2001, there were 22.35 million active workers[8] in plans insured by the agency, representing 19.7 percent of the 113.5 million private sector wage and salary workers. This represented a tiny drop in workers covered from 22.38 million in 2000.[9] In 2003, the number of single-employer plans fell to 29,512 from 31,229 the previous year. The number of multiemployer plans stood at 1,623 in 2003, down from 1,671 the previous year.[10]

The data suggest that while the defined contribution plan has become a more popular method for providing retirement benefits, it has not achieved the success that the defined benefit system enjoyed before the rise of the defined contribution plans, particularly 401(k) plans. And despite its relative decline, the defined benefit plan remains an important part of the employee benefits system, especially at larger firms. In 1998, for example, private sector defined benefit plans paid out $107.8 billion in benefits, mostly in the form of annuities disbursed from plan assets. They also purchased an additional $3.4 billion in annuities from commercial insurers.[11] Also, the defined benefit plan continues to be the plan of choice for federal, state and local government employees and for workers in the unionized sector of the economy.

The Advantages of Defined Benefit Plans

Defined benefit plans are often seen to have a number of inherent advantages for rank and file workers. Significantly, all or almost all the contributions are made by the employer. Thus, the burden of determining how much to save and how to invest those assets is shifted away from the employee to the employer or, in a negotiated plan, to the bargaining table.

Participants in defined benefit plans also enjoy a further advantage in that the investment risk is shifted away from the employee and the normal form of pension benefit is usually in the form of a lifetime annuity in an amount that can be calculated from the formula in the plan. More importantly, as recently as 1997, fewer than 25 percent of participants in defined benefit plans even had an option to take benefits in a non-annuity form, such as a lump sum.[12] In addition, the benefits provided by defined benefit plans are federally guaranteed with insurance provided by the Pension Benefit Guaranty Corporation.

Providing the retirement income benefit as an annuity eliminates the longevity risk for the retiree; that is, the retiree does not have to worry about outliving the pension, since the pension is defined as an income stream to be provided throughout the retiree's life span. It also fully meets the goals of the substantial federal tax subsidy for qualified retirement plans by providing income only during the retirement years of the employee and his or her spouse, and cannot be dissipated after a pre-retirement termination of employment or accumulated as a tax-favored asset for the next generation.

The benefit of having an automatic annuity in a defined benefit plan has, however, been eroded in recent years as more plans have opted to offer lump sums as an option and employees have chosen to take lump sums instead of annuities. In 2000, for example, 43 percent could take their benefit as a full or partial lump sum.[13]

Problems Facing Defined Benefit Plans

In order to develop new plan designs and fashion new incentives to attract employers to the defined benefit form, the group felt it was important to understand the reasons for the decline of defined benefit plans. Thus, the group explored the reasons why defined benefit plans now have less appeal to employers and, in some cases, to employees.

The Employer's Uncertainty about the Pension Liability. Many members of the group agreed that defined benefit plans have become less popular because of the unpredictability of the annual contribution employers have to make to keep their plans fully funded under federal pension laws. Such contributions are based on a series of actuarial calculations that take into consideration the promised benefits for workers, the value of assets currently in the plan, the expected rate of return that assets in the plan will likely earn in the future, and actuarial assumptions such as mortality rates and the rate of employee turnover that bear on the cost of benefit liabilities.

Employers who regularly make required contributions into their pension plans to meet future obligations can still fall short of the funding goal due to changes in the value of assets in the financial markets and due to changes in the prevailing interest rate used to evaluate liabilities. Changes in the benchmark interest rates, for example, may result in reported funding deficiencies for plans that had been previously well-funded.[14]

In recent years, declining interest rates have required employers to contribute larger sums of money. The required contribution was also increased because the value of assets in many plans declined substantially in 2000, 2001, and 2002. These year-to-year changes can make the amount of the funding obligation – the amount the employer needs to put aside now to pay benefits later – rise and fall dramatically. Thus, swings in interest rates and the market value of assets can make the funding obligation volatile. This volatility has been a key concern of employers, since it can require companies to divert financial resources needed to run the company into the pension plan. Requirements for large contributions often come when the company may not be profitable and when the failure to invest in the future of the company can weaken its prospects for success or even survival. Funding shortfalls are not always predictable since they may arise from market forces not within the employer's control.

The volatility in actual funding requirements can cause serious cash-flow problems for employers. This volatility also shows up on employers' financial statements, as accounting standards require that pension assets and liabilities be recorded both on the income statement and the balance sheet. That can have a serious impact on employers' cost of capital. Proposals under consideration by the accounting profession for market value reporting would increase the volatility on a company's financial statement by disallowing the use of some techniques that smooth, or even out, the value of assets and liabilities for accounting purposes (e.g. when assets are unusually high, smoothing will lower them somewhat; when they are unusually low, smoothing will increase them somewhat), making plan funding more predictable and less volatile.

Employees Do Not Always Value Defined Benefit Plans. The group generally agreed that one of the reasons that employers do not consider adopting defined benefit plans is that employees do not ask for them or appreciate them. Indeed, younger employees, who may expect to change jobs several times, may see a 401(k) or defined contribution plan as more valuable, since they know what assets are in their individual account and can see the assets grow over time through regular statements from the plan. However, the group also generally agreed that employees have lately shown more interest in plans that accrue funds at a regular pace with a guaranteed rate of return in response to the performance of the financial markets from 2000 to early 2003, when many employees saw the value of their 401(k) accounts plummet.

How Much Benefit for the Owners and/or Senior Management? One of the concerns about devising new defined benefit plans is not peculiar to this type of plan, but applies to all plans. Since most large and medium-sized employers have some type of employer-sponsored pension plan, most of the expansion that could occur is among small businesses. In these businesses, the owner and senior management are likely to be part of the plan that is offered, according to several members of the working group, and they would expect to receive a very large share of the pension benefits that would be financed in the plan.

People who are in the business of selling defined contribution plans, such as 401(k) plans, and profit-sharing plans – both popular among small and medium-sized employers – report that the owner and/or senior management of very small businesses normally expect to receive as much as 60 to 70 percent of the benefit. According to those who market plans, there is a tipping point for the owner and/or senior management when it is easier for the owner to simply take a similar amount of money out of the company without any tax deduction at all and set it aside for retirement outside of any qualified pension plan. Some members of the group felt that this reality of the marketplace creates an obstacle to expanding coverage. While coverage can be said to be increased if more small businesses adopt plans, this may not be significant if most of the benefit goes to higher-paid workers while rank-and-file employees do not receive meaningful benefits.

Members of the group disagreed on where new plans should set the dividing line between the portion of the retirement benefits provided to the owners and highly paid managerial employees and benefits for regular employees. Some members of the group were concerned that potential plan designs may not be attractive enough to employers to prompt them to sign up for the plan, if the plans directed too little of the contribution to owners and other highly paid employees. Others were concerned that little would be gained if new plans merely benefit owners and senior management with few benefits for the rank and file of the work force.

How the Working Group Went About Its Assignment

The members of the Working Group held six meetings and several subgroup meetings between May and November, 2003. In the initial meetings the group reviewed a number of proposals for new types of plans that promised a defined benefit.

Members were invited to express their opinions about proposals and the group sought to reach consensus on as many points as it could. Due to the nature of the process of the Conversation on Coverage, members of the group often "took off their advocacy hats" and often started from a position in the "middle" in an effort to find places where they could generally agree. At times the group was unanimous or nearly-unanimous in supporting or rejecting a given point. In this instance, the group was said to have "generally agreed" or "generally disagreed" on that point. At other times, the group found substantial agreement, but not unanimity. Sometimes the opposition was strong. When the group disagreed on a point or provision, members were invited to offer different options that might address a particular issue. This report reflects those differing opinions and varying viewpoints.

The group began its work by reviewing several defined benefit or hybrid plan proposals that were included in a binder given to all working group members. Hybrid plans have some of the characteristics of both a defined contribution and a defined benefit plan. (See Definitions of Plan Types on pages 18-20.) The group considered hybrid plans that would, at a minimum, offer a standard annual contribution by the employer (which might be waived occasionally) and would also offer a specified rate of return for the accumulated funds in the account that would be guaranteed by the employer or a financial institution or company that offers the plan.

The group devised a set of criteria[15] for reviewing proposals for new types of plans and also for reviewing proposals for tax incentives and other ideas to make existing defined benefit plans more attractive to employers and employees.

The group generally agreed that proposals should be attractive to employers and employees, make good public policy sense, and be regarded as marketable by the financial institutions and consultants who would have to sell them to employers.

For employers, the group generally agreed that the following criteria should be considered: reduced regulation, low administrative costs, low contribution costs, high benefits for owners and officers, attractiveness to prospective employees, designs that are helpful in retaining current employees, designs with tax benefits to the company and owner, designs with contribution flexibility for the owners.

For employees, the group generally agreed the following criteria should be considered: low costs in terms of contributions and high returns on assets in the plan, protection against investment risk, employee control over assets, portability of assets, protection against longevity risk, protection against inflation, tax benefits, psychological benefits of owning assets, simplicity and fairness for employees, and the adequacy of benefits provided under the proposal.

From a public policy standpoint, the members generally agreed that proposals should be measured by the effectiveness of the revenue dollars spent, and the degree to which savings are preserved for retirement rather than withdrawn earlier for other purposes. Proposals were also judged on how well they could be sold to Congress, employers and employees. They were also judged on how marketable they might be by financial institutions and benefits consultants.

The group generally agreed that the target employer market for the proposals they reviewed would be small and medium-sized businesses. Some members, however, hoped that some of the proposals that the group reviewed and eventually favored would also appeal to large businesses that may or may not have a defined benefit plan.

The Group Expresses Interest in DB-K Plans

Early in its conversations the working group expressed a preference for supporting some type of DB-K plan, with the DB referring to defined benefit and the K referring to a 401(k) plan. A DB-K plan would be, then, a defined benefit plan with a 401(k) feature. The idea behind such plans is to combine two goals into one plan: one side of the plan would provide a more secure benefit based on a guaranteed rate of return while the other side of the plan, the 401(k), would give employees a way to save for retirement through contributions that are excluded from taxable income.

The Working Group identified several potential benefits of a DB-K. It would allow employers to offer in one plan a defined benefit based on pay and length of service, as well as a retirement savings plan. It would provide a 'safe harbor' for the defined benefit plan where the employer provides a minimum benefit formula for all eligible employees, such as one percent of final average compensation times up to 20 years of service. Employers who provide this minimum benefit would be deemed to have met the requirements of the nondiscrimination rules, including the rules applicable to 401(k) plans – giving them a safe harbor from those rules. This would eliminate the need to do costly nondiscrimination testing[16] required by the Internal Revenue Code. It would allow employers to imaginatively combine the best features of defined benefit plans and 401(k) plans.

The group generally agreed to support the overall concept of a DB-K plan that would have a guaranteed benefit in one arm and a 401(k) feature in the other arm. The group, however, did not generally support any one of the three plans it reviewed. The three DB-K proposals that were discussed are described in Appendix A.

The Working Group at one point expressed interest in DB-K Proposal No. 1, which had one arm that could be either a traditional defined benefit plan or a cash balance plan. The Working Group was interested in improving on the basic features offered in DB-K Proposal No. 1 to make it more attractive for both employers and employees. The group was interested, for example, in finding ways to make it less costly for the employer by reducing the minimum required contribution. The Working Group generally agreed that employers would be more likely to adopt such plans if they were less costly. The group was also interested, for example, in allowing for withdrawals at age 59½ instead of normal retirement age to make phased retirement possible at that age, as is already possible in 401(k) plans.

The member who had introduced the original DB-K Proposal No. 3 suggested that the group replace the cash balance option with a new hybrid: the Guaranteed Account Plan, an adaptation of the money purchase plan, a defined contribution plan. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker. (See Definitions of Plan Types on pages 18-20 for more information on money purchase plans.)[18]

Working Group Offers Two Plans for Consideration. After reviewing a number of pre-existing potential designs for new types of plans with defined benefits, the Working Group settled on two proposals: the Guaranteed Account Plan (GAP) and the Plain Old Pension Plan (POPP). The two plan designs are described below.

The Working Group members generally supported the broad conceptual design of these two proposals.

Members also generally agreed on a number of key building blocks of design elements for each of the plans with reservations on some aspects of the design for the two plans.

In some key provisions, members could not reach agreement on single provisions alone without considering their impact as a whole (see section in this report on Working Group I within the discussion of GAP titled Four Policy Areas Linked in Discussions). Some members said they wanted to be sure that the package of provisions as a whole would provide lower-paid workers a sufficient share of the benefits in return for the greater flexibility and higher benefit the plan would allow higher-paid employees.

The Working Group generally supported POPP on a broad conceptual level, and there was agreement on some of its potential provisions. However, on some provisions there was disagreement. Those areas of agreement and disagreement are discussed later in this report. In some cases there are options offered for resolving issues and points of dispute.

The Guaranteed Account Plan

Areas of Broad Agreement on the Design of GAP

The Working Group reached general agreement on some of the key design elements of the proposed Guaranteed Account Plan. These elements are discussed here as individual building blocks of the overall plan.

Basic Plan Design of GAP. The group unanimously agreed on the following basic design points:

- The proposed plan is a money purchase plan with a guaranteed account balance.
- The employer credits the account of each participant with an annual contribution.
- Benefits are funded by the employer, based on standardized and conservative funding assumptions.
- Employees can also elect to contribute on a pre-tax basis.
- The employer guarantees the annual rate of return on the assets in participant accounts.
- The employer invests the plan assets in the accounts and, thus, the employees do not self-direct the investments.
- The plan offers an annuity as the automatic payment option.
- Participants may also be offered as an alternative to an annuity a lump sum equal to the amount credited to the participant's account.

With this basic design, GAP transfers from the employee to the employer the risks associated with choosing appropriate investments, as well as the financial market risk of how well investments perform and annuity purchase rates at any given time. The group did not agree on such elements as what the annual guaranteed rate of return should be and what limits should be placed on employer and employee contributions to control the extent to which highly-paid employees might disproportionately benefit from the plan.

One member strongly objected to GAP on the grounds that it was a defined contribution plan with a guarantee and not a true defined benefit plan and, thus, fell outside the Group's mission. Nevertheless, there was general agreement among members to support the broad outlines of GAP, while views differed on key provisions. Members who supported the proposal stated it preserved some of the best elements of defined benefit plans and avoided the legal controversies surrounding cash balance plans.

How Some Compromises Were Reached. In the consensus that emerged in support of key design features of the GAP, many members of the group expressed concern that some of the legislative and regulatory changes made over the years have allowed too much leakage of accumulated benefits that should be saved for retirement. Some members also expressed concerns that Congress and federal agencies have been far too willing to allow plans to favor higher-paid employees in terms of contributions and benefits. As a practical compromise, some members agreed to retain in proposed new plans, like GAP, many of what they considered to be "bad" features of current law as a practical compromise.

This was done in response to the contention that if one were to tighten existing rules for the new proposed plan, employers would be less likely to adopt the proposed plan and might either drop their current defined benefit plan in favor of the new proposed plan, or move to a defined contribution plan.

For example, many of the members would have preferred to recommend that the GAP disallow any lump sums except for the smallest accounts. However, since employers already have a lump sum option in their defined benefit plan, it was difficult to support tougher rules for GAP. As the point illustrates, the outcome on some key points on which agreement was reached was not entirely satisfactory to some concerned members. However, they decided as a practical reality that they had to preserve incentives to keep employers in existing defined benefit plans. Thus, even where members supported new various provisions in GAP, they made a point of noting that it was not an ideal structure to deliver retirement benefits and that, given the constraints of current law, it was the best compromise they could make.

With the above caveats, below are the areas where there was general agreement.

How Long Employees Work to Vest in Retirement Benefit. An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined under guidelines set forth in federal pension law.[19] The Working Group generally agreed to propose that GAP would allow employers to offer one of two types of vesting for plan participants. One choice would be to vest in the entire benefit balance all at once after three years from the date of employment, an approach called cliff vesting. The group also generally agreed to allow for gradual vesting over a six-year period. Under this approach the portion of the benefit in the plan that is vested rises each year and reaches 100 percent after six years. The vesting options under GAP are the same as those that apply now for 401(k) plans and are more generous than the rules governing traditional defined benefit plans. Shortening the vesting requirement benefits employees.

Simplified Funding Rules. Most defined benefit plans have a complicated set of rules that govern how much in new funding an employer has to contribute each year. When the total assets in a plan fall below a level that would make it difficult to meet the future benefit obligation, employers are required to close the funding gap. There are also limits on the maximum amount that can be contributed in a given year. The Working Group sought to simplify the rules in order to make GAP more appealing to employers.

The Working Group generally agreed that the employer be required to fund the plan in a manner designed to assure that plan assets are at all times adequate to meet current obligations. When the funding level of the plan falls below what it will need to meet future obligations, the plan has to schedule additional contributions to make up the amount. The Working Group generally agreed that when the plan becomes underfunded due to market performance of the assets in the plan, the gap should be closed over a five-year period, which is shorter than would be required under a traditional defined benefit plan and, thus, seen as better protection of workers' earned benefits. The employer would also be allowed to make additional contributions above those required, which could raise the level of assets in the plan to 150 percent of its current liability. This is a higher limit that current law.

The proposed funding rules for GAP reduce the amount of time the employer has to close the funding gap, compared to traditional defined benefit plans.[21] This makes it more likely plans will close their underfunding gap after they experience losses. The increase in the maximum contribution allows employers to make additional contributions in good years when the company can afford those contributions and, thus, make it better prepared for lean years, when the employer may find it difficult to make required contributions.

Increased Credit for Past Service. Members stated that plan designs that allow for past service credit may be more appealing to older employers. This feature would allow employers who have not yet set up a defined benefit plan to do so and then make contributions for the years employees worked before the plan was set up and, thus, help provide a better benefit at retirement. The Working Group generally agreed that GAP could provide for up to seven years of past service credit. The credit would be earned one year at a time for all the years of prior service credit. Thus, it would take seven years to allow for sufficient employer contributions to cover seven years of past service credit. All employees – including low and moderate income workers, as well as highly-compensated employees – would be eligible for the increased credit for past service. Consequently, the grant of past service credit would be deemed to satisfy the nondiscrimination requirements. Further, the Working Group agreed that when past service credit is allowed, it would count toward the vesting requirements of the plan.

Joint and Survivor Annuity. The Working Group generally agreed that the normal benefit offered at retirement would be a joint and survivor annuity (or a single-life annuity for unmarried participants), based on the value of the participant's account at retirement. That means the value of a participant's account would be used to purchase a commercially annuity, reasonably priced, that would be issued jointly to the plan participant and spouse and that the spouse would continue to receive the annuity should the plan participant die. Employers would be able to decide whether or not their plans would offer lump sums. However, if a participant decided he or she preferred to take a lump sum, spousal consent would be required to change the distribution from the normal requirement that it be a joint and survivor annuity. Spousal consent for a lump sum is currently required for money purchase plans, as well as for defined benefit plans.[23]

A GAP with a 401(k) Feature. The Working Group generally agreed that a GAP could also include a 401(k) feature. Employees could, under such plans, make elective contributions[24] to the GAP or the 401(k) plan.

Employer Matching Contributions. The Working Group generally agreed that employers could make matching contributions to the GAP when employees made contributions to a plan including a 401(k) feature. The Working Group agreed this should be allowed in accordance with current Tax Code requirements for matching contributions, including safe harbor rules.[25]

Calculation of Lump Sum. When employees in a defined benefit plan leave a company before retirement and they are vested in a defined benefit pension plan, they frequently receive a lump sum payment. Current pension rules governing defined benefit plans, including cash balance plans, require a complicated calculation[26] to arrive at the value of the lump sum. The group generally agreed that rather than applying the complicated rules that now affect cash balance plans, that individuals would simply receive the balance credited to their accounts, using the rules that apply to defined contribution plans. Members stated this would be fair to employees and to employers and would simplify administration.

GAP Design Elements with Some, But Not General Agreement

Rules Governing Terminations of a GAP with a Surplus. The Tax Code contains provisions that penalize companies when they terminate overfunded pension plans. Under the proposed GAP, if employers guarantee a specific rate of return, such as three percent, and the plan's assets experience higher returns, the plan will accumulate surplus assets (to the extent the funding method does not fully correct for the mismatch). An employer may wish to take a reversion on a portion of those assets. A reversion occurs when an employer terminates a plan to take out excess pension assets.

There was strong support, but not general agreement, for the following suggestions:

- **20 Percent Excise Tax on Reversions up to 130 Percent.** Employers could terminate a GAP and take the surpluses or amounts in the plan and pay a 20 percent excise tax for amounts that are up to 30 percent above the 100 percent level of account balances.
- **50 Percent Excise Tax on Reversions Above 130 Percent.** If, however, the surplus is greater than 130 percent of account balances, the employer would have to pay a 50 percent excise tax on the portion above 130 percent.

This feature was thought by members to make GAP more attractive to employers who might otherwise wish to avoid taking on the risk of guaranteeing the rate of return on account balances. This approach, one member said, would be more lenient that current law, but would not give employers "a complete pass." Nevertheless, several members strongly objected to a reduced excise tax for part of the surplus. They argued that without a significant penalty, companies would be tempted to take the surpluses and terminate plans.

Pension Benefit Guaranty Corporation Insurance. Defined benefit plans in the private sector are insured by the Pension Benefit Guaranty Corporation in Washington, D.C. When underfunded pension plans are terminated, the plan assets are transferred to the PBGC and the agency takes over the payment of pension benefits.[27] The agency guarantees pension benefits at normal retirement age and most early retirement benefits. The agency provides a maximum benefit guarantee, which is adjusted every year and is $3,801.17 per month for 2005 for workers who retire at age 65.[28]

Most of the Working Group members supported a suggestion that GAP be insured by the PBGC. One member was strongly opposed to the guarantee, arguing that PBGC guarantees were inappropriate for a plan that was not a true defined benefit plan, but a defined contribution plan with a guaranteed rate of return.

Most of the Working Group also supported charging a lower $5 premium per member in a GAP. By contrast, the flat rate premium for single-employer defined benefit plans is $19 per member per year. (In early 2005 PBGC proposed raising the flat-rate premium to $30 as part of an effort to strengthen its finances.) Plans that are underfunded have to pay an additional adjustable rate premium.[29] A lower premium was recommended to mitigate one of the objections that employers have to adopting defined benefit plans; namely, the cost of pension insurance premiums. Most, but not all, members of the group believed that the lower premium for GAP would not represent risk to the PBGC because of the low risk of a GAP benefit default.

Higher Contribution Limits and Maximum Annual Annuity Benefits. Under the Internal Revenue Code, employers can contribute more annually for high-paid older employees into defined benefit plans[30] every year than they can with defined contribution plans. The Working Group discussed whether or not GAP, which is a hybrid plan, should have the contribution limits specified for defined benefit plans or those for defined contribution plans.[31] The contribution limits for defined benefit plans are generally more favorable to older workers, which the group anticipated would often be business owners and higher-paid workers of businesses that adopted a GAP.

A majority of the group's members agreed that employers should be given a choice of whether to use defined benefit or defined contribution limits. However, some members strongly objected to this provision as providing too much of a potential benefit to owners and top executives, who are often older than the average rank-and-file worker.

The Working Group mostly agreed that GAP could use 5.5 percent as the interest rate for converting the annuity to a lump sum for purposes of the maximum defined benefit limit. The Working Group also mostly

"The Conversation on Coverage is a spectacular initiative...with the laudable goal of finding common ground at a time when there are so many divisions..."

Representative Robert Andrews (D-NJ) from his address at the Conversation's National Policy Forum, July 22, 2004.

agreed that if Congress were to change the law to provide a new interest rate assumption, the new interest rate assumption would apply to GAP. [32]

Four Policy Areas Linked in Discussions about GAP

As members discussed what provisions to approve for GAP, four key issues were frequently tied together in the conversations:

- **Minimum guaranteed rate of return on account balances.**
- **Maximum benefits allowed for higher-paid and older workers.**
- **Minimum employer contribution credits for all workers.**
- **Flexible testing methods for nondiscrimination.** [33]

There were varying levels of agreement on each of these areas. In addition, members generally agreed that whatever design the GAP proposal would have in the end would depend heavily on the combination of these four provisions. Some members suggested that it would not be possible to decide what was appropriate for each of these plan design elements in isolation without knowing what the other three would be.

A driving concern for some was a desire to be sure that lower-paid workers were able to obtain a sufficient share of the benefits in return for the greater flexibility and higher benefits the plan would allow higher-paid employees. For others, the concern was that employers be given sufficient flexibility and higher contribution and benefit levels in return for minimum contributions to all workers and guaranteed rates of return on account balances.

The four issues revolve around complicated rules of the Tax Code governing whether or not retirement plans are 'qualified,' that is, whether plans generate favorable tax benefits for the employer and employees. Those benefits, generally, are as follows: immediate tax deductions for employer contributions, deferral of income recognition for employees until benefits are distributed, and tax exempt status for the plan's funding vehicle. The most important of those rules are the complex provisions on when plans are considered to discriminate too much in favor of highly-paid employees and, thus, invalidate the tax qualified status of the plan.

Minimum Guaranteed Annual Rate of Return on Account Balances. The minimum guaranteed rate of return is a key provision since it makes the money purchase plan, a defined contribution plan, a hybrid plan with defined benefit characteristics.

The Working Group generally agreed that the rate of return could be either a fixed rate or a variable rate, meaning that it is tied to a market indicator or index. It was suggested by one advocate for the plan that the minimum be set at a three percent annual rate of return. That would mean that account balances in the account would be credited with at least a three percent gain each year. The Working Group could not agree on an appropriate fixed rate of return. The Working Group, however, generally agreed that if the rate of return were variable, it should still be the same for all employees at any given time.

Some members of the Working Group felt that the three percent minimum return was unreasonably low and does not provide adequate benefits for rank and file workers. These members preferred a five percent guaranteed rate of return. Some members argued that because higher-paid employees would be able to contribute more under the higher contribution limits and more flexible nondiscrimination tests of the GAP, they would take too great a share of the potential benefits under the plan. Other members said that if the plan required a five percent rate of return, more employers who adopted the GAP would probably opt for a variable rate to avoid this requirement.

Larger Contributions for Older Workers in Top Heavy Plans. It was proposed to require a contribution minimum of 5 percent of compensation for all workers, regardless of age, in top heavy plans, which are plans[34] where key employees have amassed benefits greater than 60 percent of the entire pool of benefits. Tax Code regulations require top heavy plans to make minimum contributions to all employees. Most small business retirement plans eventually become top heavy because the compensation of key employees is higher and because there is more turnover among other employees. This turnover means fewer of them accumulate benefits.

The group also considered a second option for top heavy plans that would allow for higher contributions to older workers and lower contributions to younger workers. Supporters of this option said it would give employers more flexibility in designing plans to meet the age demographics of their work forces. The proposed formula was as follows: Workers age 30 or under would receive contributions equal to three percent of compensation. Workers age 30 but not over age 50 would receive five percent of compensation. Workers over age 50 would receive seven percent of compensation.

The Working Group was divided on whether to support the option to provide higher contribution minimums for older workers. Some members who were opposed said that the low annual rate of return on account balances would harm younger workers. Some members who supported higher contribution rates for older workers noted that the plan would still be subject to nondiscrimination testing.

Flexible Approaches to Nondiscrimination Testing. Congress requires all qualified retirement plans to satisfy nondiscrimination rules, which are intended to ensure that such plans do not overly favor highly-compensated employees over other employees. The group engaged in lively discussions about whether GAP should import the nondiscrimination rules applicable to defined contribution plans, including complex testing methods known as age-weighting or cross-testing.[35]

In a nutshell, cross-tested methodologies allow employers to contribute substantially more (as a percentage of pay) to older plan participants, without violating the nondiscrimination rules – even if most of the older employees are highly compensated.[36] This methodology is based on the premise that a contribution to an older plan participant is inherently less valuable than the same contribution to a younger plan participant since the latter contribution will have more time to accumulate investment returns. Small firms whose owners and other favored employees were older than rank-and-file employees often used cross-testing methodologies to favor those employees. Recent variations on cross-testing methodologies allow some firms to deny the benefits of cross-testing to older rank-and-file employees by creating subgroups of participants for nondiscrimination testing, provided they contribute at least a minimum five percent of pay contribution on behalf all rank-and-file employees. (Plans that use these methodologies are sometimes called new comparability plans.) [37]

Some members of the group believed that GAP should be able to use age-weighting methodologies to prevent GAP from being at a competitive marketing disadvantage compared to defined contribution plans. Other group members argued that these methodologies were highly technical ways of directing benefits to highly compensated employees and should either not be permitted in GAP or only permitted if plans using them were required to direct additional benefits to lower-paid employees.

The group had a lively discussion on this issue, with group members articulating various views. Most of the members of the group agreed that subjecting GAP to more exacting nondiscrimination rules than those applicable to defined contribution plans would essentially mean that employers would not adopt them. One group member observed that more than 75 percent of new defined contribution plans were using cross-testing and new comparability methodologies. Moreover, the Department of Treasury, after lengthy consideration, adopted new regulations that provided minimum contribution requirements for many new comparability plans. These same rules, including the minimum contribution requirements, would apply to GAP. People who expressed this view also noted that if policy demanded limiting cross-testing methodologies, they should be limited for defined contribution plans as well as GAP and that this was an issue that was outside the Conversation on Coverage's focus on creating new plans. These group members also suggested that there would, in fact, be fewer plans if cross-testing methodologies were limited generally.

A few members of the group argued that GAP's features would attract employer interest regardless of whether or not cross-testing methodologies are available, particularly given that older highly-paid individuals could earn larger benefits in GAP than in a defined contribution plans. These members said that since a key objective of the Conversation on Coverage is to focus on rank-and-file employees, GAP should be designed in a manner that directs meaningful levels of benefits to such employees.

The group generally agreed that the use of cross-testing methodologies be conditioned on the employer providing a higher minimum benefit than would be provided for a non-cross-tested GAP. For example, under current regulation, the minimum contribution for cross-tested defined benefit plans is five percent. Consequently cross-testing methodologies would only be permitted for a GAP if the employer made a five percent minimum gateway contribution for all employees.

The group also discussed what minimum 'gateway' contribution percentage made to all employees would be appropriate for a safe harbor from nondiscrimination rules if the employer wanted to use the higher defined benefit plan maximum contribution rules. A majority of the group supported allowing cross testing only if the employer contributed six percent of pay gateway contribution for all employees in the plan.

Some members said they would be willing to support allowing cross-testing methodologies for the designated minimum gateway contribution levels if the GAP plan also provided that the minimum annual rate of return on account balances was higher than three percent.

Minimum Contribution Requirements for Nondiscrimination Safe Harbor. The members of the Working Group discussed what minimum level of contributions would be required to allow employers to avoid nondiscrimination tests.[38] Several potential arrangements were discussed: a minimum contribution for a stand-alone GAP, a minimum for a combined GAP with a 401(k) feature, and a minimum for a top-heavy GAP either alone or in combination with a 401(k). No agreement was reached on this point.

Converting from an Existing Plan to a GAP. In recent years some employers who converted their traditional defined benefit pension plans to cash balance plans encountered charges of age discrimination. Some employers were criticized for the method they used in calculating how the value of the benefit accrued under the traditional plan was determined and transferred to an opening balance in the cash balance plan.[39] As a result of strong objections that were raised, cash balance plans encountered legal and political obstacles that have yet to be resolved. To avoid the problems encountered by cash balance plans, the Working Group considered whether or not it should bar an employer with a traditional defined benefit plan from converting to a GAP.[40] Several members opposed allowing a conversion to a GAP from a traditional plan. Some members warned, however, that if a conversion to a GAP is disallowed that employers might instead convert to a defined contribution plan, a less desirable outcome than converting to a GAP, according to most group members.

The Working Group also considered whether or not to allow an employer to convert a cash balance plan to a GAP. There were some who favored allowing such a conversion provided the cash balance plan had not previously been converted from a traditional pension plan and provided the GAP were not started up by an employer following the termination of a converted cash balance plan.

The Working Group discussed whether or not it should prohibit the adoption of a GAP by a company that freezes an existing traditional defined benefit plan. There were some who opposed allowing a freeze and new GAP, unless the change was part of an agreement negotiated by a union. Some members suggested that such a prohibition might lead employers to adopt a defined contribution plan after freezing a traditional plan.

The Plain Old Pension Plan

Areas of Broad Agreement on the Design of POPP

The Plain Old Pension Plan proposal was originally introduced by a member of the group and later revised by that member and presented again to the group for discussion. In some cases, discussions surrounding issues that arose with GAP also proved helpful in discussing the provisions of POPP.

The Working Group generally agreed to the components of the plan as spelled out in this section. The basic design elements are as follows:

- The plan is a simple, easy-to-understand traditional defined benefit plan that provides a modest basic benefit to allay employer concerns about funding the plan.
- The final basic benefit is based on a percentage (as low as one percent) of an employee's career average pay multiplied by the number of years of service.

- The plan would allow employers to fund bonus benefits in any given year or years that would raise the final benefit without having the bonus benefits become part of the permanent benefit structure.
- The plan would permit, but not require, a generous past service credit that would be attractive to small business owners.
- All benefits from the plan would be paid in the form of an annuity. Lump sum distributions would not be permitted.

Basic Plan Benefit. The basic plan benefit would accrue at one percent a year of the career average income times the number of years of service. To make the calculations simpler, plans could rely on tables published annually by the Treasury Department or the Pension Benefit Guaranty Corporation that would be expressed as a table using age and compensation to determine the contribution each year. The amounts set forth in the table would be determined by the governmental agency using very conservative actuarial assumptions. Employers would calculate each year's required contribution by aggregating the contributions on the table for each participant. Some members of the Working Group suggested that the government publish the actuarial tables required in this plan every 5 years instead of annually. The actuarial assumptions in the tables would be conservative, to make funding shortfalls unlikely.

Employees Covered. The plan would cover all employees who meet the minimum service requirements, including part-time employees. Employers would not be required to cover seasonal employees (but could, if they wished). Thus, the plan would typically cover a secretary who worked three days a week, but not a college student working for the summer. If the employer has separate lines of business, the plan could be adopted for one line of business only.

Vesting. An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined for most plans under guidelines set forth in federal pension law.[41] As modified, this proposal would allow for either three-year cliff vesting or two- to six-year graded vesting. With cliff vesting the participant becomes entitled to the benefit balance that has accrued all at once after three years from the date the participant joined the plan. Under graded vesting, the portion of the benefit in the plan that is vested rises in equal portions each year until it reaches 100 percent after the graded vesting period. Vesting would only count service from the date POPP was adopted unless the employer chose to count years prior to adoption of POPP.

Past Service Credit. The plan allows for past service credit for as many years as the employer would like. The past service credit would have to be amortized; that is, funded in regular installments over a seven-year period.[42] Likewise, employees would accrue the past service credit over a seven-year period. An employer could give past service credit for benefit purposes without giving vesting credit for those years.

Bonus Benefit. In years when the investments in the plan do very well, in years when the company's profits are strong, or at any other time, the employer may give a bonus benefit to employees without committing to a permanent benefit increase. For example, in good years employees could accrue a benefit of two percent of compensation instead of one percent. Or, the employer might increase the benefit by the cost-of-living, and such COLAs would be treated as a bonus benefit for the years they covered.[43] Past service credit could also be given for a bonus benefit.

Minimum Benefit. There would be no required minimum benefit even if the plan is top heavy because the minimum benefit is built into the benefit formula, which provides the same level of benefits for all employees.

401(k) Feature. The plan could contain a 401(k) feature. Participants could 'buy' more retirement income through contributions using the Government tables to determine the cost. Or, the employer could offer a separate 401(k) plan with an employer match for employee contributions and profit sharing contributions that would be invested in the traditional 401(k) investments.

Simplified Funding Rules. POPP was designed to simplify the funding rules and reduce employer concerns about the plan developing large unfunded liabilities that might overwhelm a small business. For this reason, the plan will allow for an approach that will smooth changes in actuarial assumptions, as well as gains and losses in the assets held in the plan. As proposed, the plan would be subject to periodic actuarial valuations, primarily to assess investment experience since mortality and interest rates would be covered automatically under tables. Investment experience would be smoothed by using a ten-year rolling average of the asset valuation (or, if less, the number of years since the plan was established). Investment shortfalls would be funded in installments over five years. However, the use of conservative actuarial assumptions is likely to significantly reduce the chances that plans will have funding shortfalls.

Joint and Survivor Annuity. The plan was designed to have withdrawals from the plan be made in the form of a qualified joint and survivor annuity. Lump sums would not be allowed.

Terminated Participants. Under the proposed plan design, the benefits of terminated participants could be transferred to the Pension Benefit Guaranty Corporation, the federal agency that insures pension benefits – or held in the plan for distribution at retirement age.

Pension Benefit Guaranty Corporation Insurance. The plan would be insured by the PBGC and would pay $5 premiums, lower than those paid by traditional pension plans. When plans are terminated, the plan assets are transferred to the PBGC and the agency takes over the payment of pension benefits.[44] The agency guarantees pension benefits at normal retirement age and most early retirement benefits.[45] The agency provides a maximum benefit guarantee, which is adjusted every year and is $3, 801.17 per month for 2005 for workers who retire at age 65.[46] By contrast, the flat rate premium for single employer defined benefit plans is $19 per member per year. (The PBGC in early 2005 proposed raising the flat rate premium to $30 as part of an effort to strengthen its finances.) Plans that are underfunded have to pay an additional adjustable rate premium.[47] A lower premium was recommended to mitigate one of the objections that employers have to adopting defined benefit plans; namely, the cost of pension insurance premiums.

Plan Termination. If the plan is terminated, there would be no reversion of any surplus assets to the employer. Under current law, overfunded plans can be terminated and a portion of the surplus can be transferred to the employer who sponsored the plan. The process of transferring the funds back to the employer is called a reversion. Under this provision, the excess would be used to increase benefits of current employees to compensate them for the lost opportunity to accrue more benefits. It could also be used to increase benefits for retirees. Some members of the Working Group objected to the proposed reversion rules and suggested instead that the plan be governed by existing reversion rules.

Conversion to Traditional Defined Benefit Plan. The plan could be amended at any time to become a more traditional defined benefit plan. The converted plan would be permitted to use all available nondiscrimination testing methodologies available to regular defined benefit plans.[48] After conversion, the employer would adopt its own actuarial assumptions and run the converted plan like a traditional defined benefit plan, including provide a minimum benefit to all workers eligible to participate if the plan is top heavy.[49]

Tax Credit. As proposed, the plan would allow employers a tax credit equal to five percent of the contributions made to fund benefits for non-highly compensated employees[50] for a period of five years. The credit would be recaptured by the Internal Revenue Service if the employer terminates the plan within five years. This provision would help employers cover the costs of providing the benefits to all workers, including part-time workers who are not seasonal workers.

The Working Group generally agreed that the tax credit should be higher than five percent and should be similar to the level of the Saver Credit, which provides a 50 percent credit for contributions up to $2,000. Members also said the tax credit for POPP could be similar to a temporary tax credit that was offered on contributions to PAYSOPS, Payroll Stock Ownership Plans.

Some members of the Working Group were worried that the tax credit might be an incentive for an employer to convert a more generous traditional defined benefit plan to a POPP. A member suggested that the tax credit be limited to the first five years of the plan.

Required Legislative Changes. The proposed provisions of POPP are mostly available under current law. However, legislation would be needed to authorize the PBGC to issue contribution tables, to operate terminated, sufficient plans, and to act as a clearinghouse for rolled over or transferred benefits. Legislation would also be needed to permit a 401(k) feature in a defined benefit plan, and enact the tax credit for contributions for non-highly compensated employees.

The Working Group discussed POPP and its proposed provisions and generally agreed that the plan had attractive features and that they should offer it as a plan to be considered by employers, employees, consultants, plan providers and policymakers. The Working Group also agreed that the plan would garner more attention from potential employers and plan providers if the required legislative changes were enacted by Congress.

Several members expressed doubt that Congress would be interested in supporting a new type of defined benefit plan. One member suggested that while Congress might not be receptive to the idea of supporting a new defined benefit plan, it was helpful nevertheless for the Working Group to put forward an idea that the members generally agreed had merit. Some members remained skeptical that POPP was sufficiently attractive to employers and some questioned whether it would be marketed by financial institutions and other prototype plan providers. One member said that the proposed benefit based on one percent of income might be too low to attract the enthusiasm of employees.

Tax Incentives for Expanded Coverage

The Working Group submitted ideas for tax incentives that would encourage employers to maintain or extend defined benefit plan coverage to more employees. These included ideas to reward companies for retaining a defined benefit plan, ideas for adopting specific provisions that would expand coverage, as well as incentives to start-up new defined benefit plans.

The members considered 13 tax credit ideas and supported some and rejected others.

Tax Credits Generally Supported by the Working Group:

Immediate Vesting. The Working Group generally supported giving employers a tax credit to provide immediate vesting of benefits.

100 Percent Coverage of Employees in a Single Line of Business. The Working Group generally supported tax credits for this goal.

Reduction of the 1,000 Hours Requirement for Plan Participation and Benefit Accrual/Allocation. The Working Group generally supported the idea of giving a tax credit for reducing the requirement to 500 hours for part-time workers. They also agreed that seasonal workers could be excluded from the 500-hours requirement.

Tax Credits With Some Support by the Working Group:

Establishment and Maintenance of a Defined Benefit Plan. The Working Group discussed several options for rewarding employers for establishing and maintaining a defined benefit plan. One member proposed giving employers a tax credit equal to the cost of PBGC premiums every fifth and tenth year. Other members thought this would be too expensive.

Providing an Annuity Option Only. There was support within the Working Group for tax credits for defined benefit plans that adopt a policy that benefits be offered only as an annuity, provided there was a threshold level of a minimum amount of benefit for the requirement there be an annuity. Some supported a policy of exempting balances of $50,000 from the annuity requirement, while others suggested that the group should not set a dollar amount but ask the Department of Labor, PBGC, and Treasury to determine a level below which there is not a viable annuity market. Members supporting this provision said that the PBGC might be encouraged to offer annuities not provided by commercial users. One member, however, questioned the appropriateness of providing tax credits to employers "to lock up the money" of employees and recommended instead that employees be given the tax credit for taking their benefit as an annuity.

Plans Not Permitting Pre-Retirement Age Distributions. There was support in the Working Group for tax credits for plans that adopted this prohibition, with an exception for benefits worth less than $5,000. It was seen as supporting the goal of building more assets for retirement. One member suggested that rollovers for those who leave a company before retirement be made to an IRA that restricted the final benefit to an annuity. One member, however, questioned the appropriateness of giving tax credits to employers to limit options for employees.

No Use of Permitted Disparity. The Working Group considered a suggestion that a tax credit be provided to an employer that did not use nondiscrimination testing methods that permit disparity.[51] The group was divided on whether or not to support a tax credit for this prohibition.

What Can Be Done Next

The Conversation on Coverage in its next stage will consider what further steps it can take to promote coverage through adaptations of the two new major plan designs – GAP and POPP – to emerge from Working Group I. The participants of the Working Group will concentrate on refining the outstanding issues of GAP to develop a fully-formed proposal, as well as complete development of the POPP proposal. The Conversation will examine the feasibility of potentially launching a demonstration project in which a plan, like POPP, might be marketed through financial institutions.

Definitions of Plan Types

Defined Benefit Plan

A defined benefit plan is a pension other than an individual account plan that provides a regular monthly income after retirement that is determined according to a formula. It is not dependent on the actual contributions made to the plan or investment performance of the plan's assets. Benefits typically are determined based on a fraction[52] of a worker's average earnings (either career earnings or certain high earnings years at the end of the worker's tenure), or a flat dollar amount multiplied by the number of years worked for the employer. For example, a defined benefit plan might offer employees a monthly retirement benefit equal to one percent of average compensation a year multiplied times the number of years worked. In this instance, if a worker averaging $40,000 a year worked 20 years, he or she would earn one percent of $40,000 or $400 multiplied by 20 or $800 a month ($9,600 a year). In the alternative, a plan might promise a benefit of $40 per month times the number of years worked. If a worker put in 20 years of service, he or she would also receive $800 a month or $9,600 a year. The maximum benefit payable by a defined benefit plan in 2005 is $170,000 a year.

Some newer defined benefit plan designs provide benefits that mimic the appearance of defined contribution plans, reporting benefits as a lump sum account balance (See Cash Balance Plans below.)

Private sector defined benefit pension plans must provide annuities – either single life annuities for unmarried participants or joint and 50 percent survivor annuities for married participants – as the default form of benefit. The annuity from a defined benefit plan helps retirees (and their surviving spouses) by assuring them of a regular income based on a set formula for the rest of their lives.

Not all retirees receive their defined benefit as a regular monthly stream of income, known as an annuity. Instead, some employers allow retirees to receive their accumulated benefit as a lump sum (with the consent of their spouses). If a retiree elects to take a lump sum where it is allowed, that retiree is responsible for deciding how to manage and invest those funds, as well as when and how much to pay out as an income.

In a defined benefit plan, the worker does not have to make decisions about how to invest assets contributed by the employer into the plan. The employer is responsible for determining the amount of contributions needed to fund the promised benefits, making those contributions each year, investing the assets in such a way they will earn a sufficient return to provide for the funds needed to pay the promised benefit, and making up for any shortfall in the assets. Most benefits provided by defined benefit plans are guaranteed by the federal pension insurance program managed by the Pension Benefit Guaranty Corporation. The maximum insured annual benefit for 2005 is $ $45,614.

Defined Contribution Plan

A defined contribution plan is one that provides workers with an individual account and pays out benefits equal to contributions to the account and net investment earnings on the contributions. The 401(k) plan is the most well-known example of this type of plan. In a 401(k) plan, contributions can be made by the employer or the worker and employers often 'match' employee contributions; that is, they provide an additional contribution tied to the amount of contribution the employee makes. In some defined contribution plans – typically 401(k) plans – employees must decide how to allocate all or part of their account balances among a set menu of investment options selected by the employer (e.g., among various mutual funds and employer stock). In other kinds of defined contribution plans – such as profit sharing, money purchase, and employee stock ownership plans – contributions are made by the employer. In these plans, the employer often invests the money in the employees' accounts.

In most defined contribution plans, workers receive their benefits as lump sums when they leave their jobs. They may either roll over the account balance to an IRA or a new employer plan or use the money for other, nonretirement purposes. Defined contribution plans, other than money purchase plans (discussed below) are not required to offer annuity payouts and most do not. Upon retirement, an employee has an accumulated retirement savings that he or she will have to decide how to manage. The retiree has to decide whether to take part or all of the assets as an annuity, if that is an option. Or, perhaps the retiree may choose to set up a schedule of regular withdrawals. The retiree also has to decide how to invest the assets in retirement, including whether to change the asset allocation. With the 401(k), there are minimum distribution rules, which dictate a minimum withdrawal each year beginning at the age of 70?. Defined contribution plans, unlike defined benefit plans, are not insured by the Pension Benefit Guaranty Corporation.

Hybrid Plan

A hybrid plan has characteristics of both defined benefit plans and defined contribution plans. The most common hybrid plan is the cash balance plan.

Cash Balance Plan

A cash balance plan is a defined benefit plan that defines the benefit as a stated account balance. In a typical cash balance plan, each worker is credited on a periodic basis with a **pay credit**, a percentage of one's earnings, and an **interest credit**, which sets the rate of return for the account balance for that year. The interest rate can be either a fixed rate or a variable rate. Although cash balance benefits are reported as individual account balances, these accounts are only hypothetical. Workers' benefit amounts are unrelated to the employer's actual cash contributions to the plan and unrelated to the actual investment performance of plan assets. The benefit is based on the accumulated amount credited to each employee's account.

As with all defined benefit plans, employers must offer employees the option of taking the benefit as an annuity as the default form of benefit.

Money Purchase Plan

The money purchase plan is an employer-sponsored defined contribution plan that allows employers to contribute a set percentage of compensation for workers into the plan with a maximum annual contribution of $42,000 in 2005. This is the maximum for all defined contribution plans and, thus, is not a unique design element of the money purchase plan. Once an employer establishes a contribution level, the amount in subsequent contributions must be maintained until the employer makes a formal, prospective pronouncement that the contribution will be decreased or discontinued. Thus, contributions are made whether or not the business has a profit, which differentiates the money purchase plan from a profit-sharing plan, where contributions are made to employees' accounts at the discretion of employers, usually when there are profits. Unlike other defined contribution plans, money purchase plans must provide joint and survivor annuities for married participants and single life annuities for unmarried participants.

Appendix A

DB-K Proposals Considered by the Group

Three DB-K proposals were considered by the group, one from the American Society of Pension Actuaries (ASPA), one from the American Academy of Actuaries (AAA) and one from The Principal Financial Group. The proposals share common design features. Each provided both a defined benefit formula and the opportunity for workers to make tax-deductible contributions from their wages and salaries to a defined contribution plan. Each plan provided a minimum defined benefit to all participants. All of the plans are designed to avoid nondiscrimination testing if they promise minimum benefits, and the plans have simplified rules for funding the defined benefit portion of the plan.

DB-K Proposal No. 1. Under this proposed plan[53] from the American Society of Pension Actuaries, there would be a single trust established for both the 401(k) and either a traditional defined benefit plan or a cash balance plan. However, the trust would have strict recordkeeping requirements whereby the assets of each of the defined benefit and 401(k) components of the plan would be accounted for separately. Accordingly, for example, any excess assets associated with the defined benefit portion of the plan could not be used for purposes of employer contribution requirements to the 401(k) portion of the plan.

An advocate of this proposal suggested that many employers would likely choose a cash balance design over a traditional defined benefit plan for the defined benefit portion of the plan. The cash balance plan is a hybrid plan in which the employer credits contributions to a hypothetical account for each employee and guarantees a rate of return on money deemed to be allocated to those hypothetical accounts. (See definitions of plan types on pages 18-20 for information on cash balance plans.) The accumulated balance is converted to an annuity for payment at retirement age, but is typically made available as a lump sum payment.

In order for employers to take full advantage of the concept, the ASPA proposal would require under the defined benefit portion of the plan a minimum benefit formula for eligible employees of one percent of final average compensation times up to 20 years of service. The proposal would offer employers a cash balance design option instead of a traditional defined benefit design. For the cash balance design alternative, the proposal contemplates that employers would credit an annual contribution for eligible employees to their hypothetical cash balance accounts equal to five percent of compensation. However, the proposal also permits employers to increase contribution levels for older workers on a graduated basis so that the plan more closely mirrors the increased benefit values for older workers provided under a traditional defined benefit plan.[54] The plan also offered employers the choice of making a minimum contribution of five percent of pay to both the defined benefit and defined contribution side of the plan. The ASPA DB-K would also allow for additional accruals to the defined benefit arm of the plan based on what portion of income is contributed from compensation to the 401(k) side of the plan. In other words, employers could match employee contributions to the 401(k) plan by enriching the defined benefit side of the plan. There was considerable interest among members of the group in the plan, although there was some concern it might be an expensive plan, especially the graduated cash balance benefit.

DB-K Proposal No. 2. The Principal DB-K plan was similar to the ASPA DB-K plan. However, it offered only a traditional defined benefit plan and not a cash balance option. The traditional defined benefit portion of the plan was designed to provide a worker who put in 20 years of service an income equal to 25 percent of career average pay. It also offered an option where the benefit could also accrue at a higher rate over ten years.

DB-K Proposal No. 3. The DB-Plus Plan from the American Academy of Actuaries would allow employees to make pre-tax contributions to the defined benefit side of the plan. It would also allow for employer matches to employee contributions to the defined benefit side of the plan. Supporters of the DB-K Plus plan would seek legislative or regulatory clarification on current rules that would allow for employers who sponsor the plan to offer a higher rate of return for funds in the defined benefit side than is currently available under Internal Revenue Service rules to solve the so-called 'whipsaw' problem.[55] The plan would also allow for tax credits for contributions on behalf of low-income employees to be deposited into the plan. [56] The plan encourages employers to set up an automatic default election that would put new employees into the plan with automatic contributions of one percent to six percent of pay (with increases when salaries increased) unless the employee affirmatively requests otherwise. The DB-K Plus also allows for distributions beginning at age 59½ even without termination of employment. Allowing distributions at age 59½ would allow members to have a phased retirement beginning at that age. The PBGC would insure all of the benefits of the DB-K Plus, as long as it was funded appropriately. Some members were concerned that because both the defined benefit plan and the 401(k) are in a single trust, it could mean that the PBGC would be deemed to have guaranteed the 401(k) side of the combination. Others raised concerns that the proposal would allow excess assets associated with the defined benefit component of the plan to be used to offset the cost of employer contributions under the 401(k) component of the plan.

Appendix B

Proposals Considered and Not Endorsed

Risk-Splitting Defined Benefit Plans. After its May 2003 meeting, the group formed a subgroup on risk-splitting. Several suggestions to share the risk of market performance between the employer and the employees were advanced for consideration. A proposal was considered for guaranteeing only 75 percent[57] of the final benefit liability. Under this approach, the employee would share some of the risk associated with the funding obligation for 25 percent of the benefit, while the employer still retained responsibility for 75 percent. The group generally did not support any of the risk-splitting proposals. Those objecting stated such an approach would put additional burdens on the Pension Benefit Guaranty Corporation (PBGC), which insures defined benefit plans. The PBGC would face the difficult task of determining how much of the benefit should be paid if a plan is terminated and taken over by the agency. One member said that Congress would not be receptive to the idea of transferring risk to employees.

Some members suggested that risk-splitting raises a question about whether employees should also share in some of the gains if a plan over-performs, and also whether employees should have a role in selecting investments. One member suggested it would be difficult to determine how much of a plan's underfunding was due to poor market performance and how much was due to the employer failing to make regular, adequate annual contributions. There was also concern about the complexity of the risk-splitting proposals before the group. Finally, some suggested that risk-splitting could already be accomplished by an employer sponsoring both a defined benefit plan and a defined contribution plan. While some members of the group believed that the concept of risk-splitting had some merit, no one suggested it should be listed as a group recommendation.

SAFE Proposal. SAFE stands for The Secure Assets for Employees Plan, which was introduced as legislation in 1997 by Rep. Nancy Johnson (R-CT) and Rep. Earl Pomeroy (D-ND).[58] This plan was designed to provide a minimum defined benefit that would be 100 percent funded.[59] It would be funded either by an individual retirement annuity or through a trust. SAFE sought to reduce the regulatory burden on employers, to reduce uncertainty about potential unfunded liabilities and to give employers more flexibility in managing the plan than is possible with traditional defined benefit plans.[60] Members of the group discussed the proposal but declined to endorse it. [61] Members suggested that the group should come up with new proposals and not revisit previous proposals. Some members, noting the group's greater interest in other proposals, cautioned against possibly supporting too many proposals. Some group members also expressed concern that SAFE permitted designs under which business owners could capture too much of the plan's aggregate benefits.

SMART Proposal. SMART stands for a Secure Money Annuity or Retirement Trust Plan, which was introduced by the Clinton Administration in February 1998 as a hybrid plan designed for business with fewer than 100 employees. Like the SAFE proposal, the SMART would offer a minimum guaranteed benefit at retirement[62] with the potential for additional investment return if the assets perform above the base 5 percent benchmark.[63] It would also be funded by an annuity or a trust. Members of the group discussed the proposal but declined to endorse it. [64] As with the SAFE, members were in favor of new proposals rather than revisiting previous proposals.

Improved Cash Balance Plans. The group discussed ways to make cash balance plans more attractive. Cash balance plans have been criticized for discriminating against older workers at some companies that switched from a traditional defined benefit plan to a cash balance plan. While some members strongly opposed cash balance conversions, there was some interest in cash balance plans that are started *de novo* by a company that previously did not have a defined benefit plan. Proposals to make cash balance plans more attractive included reduced insurance premiums for fully-funded cash balance plans and other ideas.[65] Despite interest in this challenge, the effort to improve cash balance plans was eventually set aside, largely because some court decisions and regulatory issues had clouded the outlook for such plans and strong political opposition had emerged to the plans.

A List of Incentives to Improve Coverage at Defined Benefit Plans. The group decided to create a list of tax incentives that would encourage desired behavior with respect to defined benefit plans, including such ideas as supporting tax credits for employers who expand pension coverage to part-time workers. The ideas the group supported are discussed earlier in this report.

Other Ideas Listed in the Binders. The group also briefly reviewed other proposals from a list included in the binder and chose not to consider further any of those plans for endorsement. One proposal considered was by Ted Groom and John Shoven to eliminate most of the federal rules governing pension plans, including nondiscrimination rules, as well as pension insurance and the Pension Benefit Guaranty Corporation. It was suggested by Groom and Shoven that more employers would offer plans if there were fewer rules governing them. The group also briefly discussed, but did not support, a proposal identified as the Individual Advantage Plan from Jim Davis of Milliman & Robertson that would allow workers the choice of the greater of a cash balance or a traditional formula.[66]

Other Ideas Proposed by Members. The working group also considered ideas proposed by its members during its discussions. One member proposed eliminating the lump sum option for defined benefit plans. Increasingly, workers have chosen to take lump sums instead of an annuity, which provides a stream of monthly payments that continue as long as the annuitant lives. This idea was seen by some as being beyond the scope of the group's mission to expand coverage. The suggestion was also criticized because it can be costly for small businesses to purchase individual annuities, which might lead some small businesses to switch from a defined benefit plan to a defined contribution plans. One member suggested that lump sums could be deposited into a central clearinghouse and, thus, avoid the high costs of purchasing individual annuities. There was some support for this approach, with one member suggesting that the PBGC could be the clearinghouse. The group, however, did not further refine the proposal.

Appendix C

Contribution Calculations for the Guaranteed Account Plan

Case Study Showing Funding Method Over a Seven-Year Period

Synopsis of funding calculation:

(1) Calculate total of hypothetical contributions for the plan year

(2) Calculate the value of the assets as of the valuation date, before any current contribution is added

(3) Calculate the sum of the Guaranteed Account Balances (GABs) as of the valuation date (excluding (1))

(4) Subtract (3) from (2). If this is a positive number, there has been an earnings gain. If this is a negative number, there has been an earnings shortfall.

(5) If (4) is a net loss, calculate the amount that the earnings shortfall would be worth in 5 years (including the current year) under the plan's guaranteed rate of return (assume current year guarantee if the rate can fluctuate).

(6) Calculate the amount that would be required to be contributed as of the valuation date to amortize the amount in (5) over the 5-year period.

(7) Calculate the aggregate GABs as of the valuation date, including the amount in (1).

(8) Subtract the amount in (2) from the amount in (7). This is the unfunded portion of the GABs. If (2) is larger than (7), the GABs are fully funded, and this amount is zero.

(9) Minimum funding: The lesser of: (a) the amount in (1) plus the amount in (6), or (b) the amount in (8).

(10) Maximum funding calculation (maximum deduction):

(a) Calculate 1.5 times the amount in (7)
(b) Subtract the amount in (2) from the amount in (10)(a). If this is a positive number, this is the most the employer can contribute on a deductible basis. If this is zero or a negative number, the maximum deduction is zero (i.e., the full funding limit).

(11) Limitations on funding assumptions: pre-retirement discounts for turnover and mortality not permitted, no salary scale assumptions.

(12) Plan is a money purchase plan for IRC §412 purposes, but is subject to the special minimum funding requirements stated above. Therefore, there would be no quarterly contribution requirement under IRC §412(m).

(13) When calculating the aggregate Guaranteed Account Balances, a participant's account must be limited to the maximum lump sum permitted under IRC §415(b) if the account were to be distributed as of the valuation date.

Case Study

A GAP is established which promises a 6% hypothetical contribution, and a 5% guaranteed rate of return. Contribution is allocable as of the last day of the plan year.

Year 1: Total participant compensation is $1,000,000
Normal cost = $60,000

(This is the total compensation times the hypothetical contribution rate. There were no prior year contributions, so no guaranteed return for the first year.)

GABs as of valuation date: $60,000.

No earnings shortfall because the plan does not have any experience on the first valuation date.

Minimum funding: $60,000

Maximum funding: $90,000

Employer's actual contribution: $60,000

Year 2: Total participant compensation is $1,100,000.

Normal cost = $66,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,100,000)

Actual earnings since last valuation date: $2,392 (about 4%)

Total value of assets as of the valuation date (before current year contribution is made): $62,392

The guaranteed return for this valuation period on the GABs from the prior valuation date: $3,000

GABs as of valuation date (excluding current year's contribution): $63,000 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $608 (i.e., assets minus pre-contribution GABs). This would be worth $776 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $140 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $66,140

Sum of GABs as of valuation date (including current year's contribution): $129,000

Shortfall on 100% funding: $66,608 (i.e., $129,000 minus $62,392)

Minimum funding amount: $66,140 (i.e., the lesser of the normal cost plus]payment or the 100% funding shortfall)

150% x GABs: $193,500

Maximum funding is: $131,108 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $66,500

Year 3: Total participant compensation is $1,340,000.

Normal cost = $80,400. This is determined by calculating the hypothetical contribution for this year (6% x $1,340,000)

Actual earnings since last valuation date: $1,154 (only a 1% rate of return).

Total value of assets as of the valuation date (before current year contribution is made): $130,045

The guaranteed return for this valuation period on the GABs from the prior valuation date: $6,450

GABs as of valuation date (excluding current year's contribution): $135,450 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $5,405 (i.e., assets minus pre-contribution GABs). This would be worth $6,897 in 5 years under the plan's guaranteed rate of 5%.
Amortization payment for shortfall: $1,248 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $81,648

Sum of GABs as of valuation date (including current year's contribution): $215,850

Shortfall on 100% funding: $85,805 (i.e., $215,850 minus $130,045)

Minimum funding amount: $81,648 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $323,775

Maximum funding is: $193,730 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $82,000
Year 4: Total participant compensation is $1,500,000.

Normal cost = $90,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,500,000)

Actual earnings since last valuation date: -$3,908 (a negative rate of return).

Total value of assets as of the valuation date (before current year contribution is made): $208,137

The guaranteed return for this valuation period on the GABs from the prior valuation date: $10,792.50

GABs as of valuation date (excluding current year's contribution): $226,643 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $18,505 (i.e., assets minus pre-contribution GABs). This would be worth $23,618 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $4,274 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $94,274

Sum of GABs as of valuation date (including current year's contribution): $316,643
Shortfall on 100% funding: $108,506 (i.e., $316,643 minus $208,137)

Minimum funding amount: $94,274 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $474,964

Maximum funding is: $266,827 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $99,000

Year 5: Total participant compensation is $1,400,000.

Normal cost = $84,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,400,000)

Actual earnings since last valuation date: $17,224 (6% rate).

Total value of assets as of the valuation date (before current year contribution is made): $324,362

The guaranteed return for this valuation period on the GABs from the prior valuation date: $15,832

GABs as of valuation date (excluding current year's contribution): $332,475 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $8,113 (i.e., assets minus pre-contribution GABs). This would be worth $10,355 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $1,874 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $85,874

Sum of GABs as of valuation date (including current year's contribution): $416,475

Shortfall on 100% funding: $92,113 (i.e., $416,475 minus $324,362)

Minimum funding amount: $85,874 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $624,712
Maximum funding is: $300,350 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $100,000

Year 6: Total participant compensation is $1,600,000.

Normal cost = $96,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,400,000)

Actual earnings since last valuation date: $36,368 (9% rate).

Total value of assets as of the valuation date (before current year contribution is made): $460,729

The guaranteed return for this valuation period on the GABs from the prior valuation date: $20,824

GABs as of valuation date (excluding current year's contribution): $437,298 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $0 (the plan is now running at an experience gain)

Amortization payment for shortfall: $0 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $96,000

Sum of GABs as of valuation date (including current year's contribution): $533,298

Shortfall on 100% funding: $72,569 (i.e., $533,298 minus $460,729)

Minimum funding amount: $72,569 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall); the plan will have to be brought to full funding this year

150% x GABs: $799,948

Maximum funding is: $339,219 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $200,000 (Things are going well, the employer puts in extra for a rainy day and to get a bigger deduction)

Year 7: Total participant compensation is $2,000,000. Normal cost = $120,000. This is determined by calculating the hypothetical contribution for this year (6% x $2,000,000)

Actual earnings since last valuation date: $31,009 (5% rate).

Total value of assets as of the valuation date (before current year contribution is made): $691,738

The guaranteed return for this valuation period on the GABs from the prior valuation date: $26,665

GABs as of valuation date (excluding current year's contribution): $559,963 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $0 (the plan is still running at an experience gain)

Amortization payment for shortfall: $0 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $120,000

Sum of GABs as of valuation date (including current year's contribution): $679,963

Shortfall on 100% funding: $0 (i.e., assets exceed the GABs)

Minimum funding amount: $0 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $1,019,945

Maximum funding is: $328,207 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $0

Appendix D

Contribution Calculations for the Plain Old Pension Plan

Compensation Age	$30,000/year	$60,000/year	$100,000/year	$200,000/year
30	$585	$1,170	$1,950	$3,900
40	$960	$1,920	$3,200	$6,400
50	$1,584	$3,168	$5,280	$10,560
55	$2,043	$4,086	$6,810	$13,620
60	$2,666	$5,333	$8,888	$17,776
65	$3,537	$7,074	$11,790	$23,580

Mortality Assumption: 1994 Group Annuity Mortality table projected to 2002*
Interest Rate Assumption: 5%
Plan Formula: 'A lifetime pension = 1% times current compensation at age 65, payable monthly

**This is the mortality table required by IRS to calculate minimum lump sums from pension plans.*

Endnotes

[1]Traditionally defined benefit plans were designed to provide workers with a replacement income that, when combined with Social Security, would be sufficient enough to maintain their standard of living. However, some defined benefit plans are not designed to provide a replacement rate sufficient to maintain a worker's standard of living. Instead, they may be designed to provide supplementary income with a predictable income stream to add a worker's retirement income. For this reason, employees with a defined benefit plan will still need to assess how much they need in retirement and how determine much they may need to save to provide a sufficient replacement income beyond the income that will be available from Social Security and a stream of income from a defined benefit plan.)

[2]The normal benefit is an annuity, but many defined benefit plans offer a lump sum or other payout options. If a retiree does not elect an annuity, then the retiree is faced with the task of managing the lump sum over his or her retirement years. Increasingly, retirees from defined benefit plans can also select a lump sum option. In 2000, 45 percent of full-time private sector employees worked at firms with defined benefit plans offered a lump sum option, according to the Bureau of Labor Statistics. To the extent that retirees select a lump sum option, they must then also devise a plan for managing those assets during retirement.

[3]Private sector pensions insured by the Pension Benefit Guaranty Corporation are guaranteed up the statutory limits, now roughly about $44,000 if the benefit starts at age 65.

[4]From Department of Labor data for 2000 and 2001, as reported in Constantijn W. A. Panis, "Annuities and Retirement Satisfaction," Pension Research Council Working Paper PRC WP 2003-19, The Wharton School, University of Pennsylvania, mimeo, 2003, p. 8.

[5]Ibid..

[6]Patrick J. Purcell, "Pensions and Retirement Savings Plans: Sponsorship and Participation," (Washington, D.C. Congressional Research Service, October 22, 2003), p. 5.

[7]Ibid.

[8]Pension Benefit Guaranty Corporation, Pension Insurance Data Book, April 2004, Table S-33, p. 57.

[9]Ibid.

[10]Ibid, Table S-31, p. 55 and Table M-6 on p. 84.

[11]U.S. Department of Labor, Pension and Welfare Benefits Administration (now the Employee Benefits Security Administration), Abstract of 1998 Form 5500 Annual Reports, Private Pension Plan Bulletin, Number 11 (Winter 2001-2002).

[12]U.S. Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1997, Bulletin 2517 (Washington, D.C.: U.S. Department of Labor, September 1999), Table 133, p. 107.

[13]U.S. Department of Labor, Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, 2000, Bulletin 2555, January 2003, p. 66, Table 78.

[14]The 30-year treasury rate is used for calculation of the deficit reduction contribution and certain other purposes. In recent years Congress has provided temporary relief from the 30-year Treasury rate as the standard for calculating the benefit obligation. For plan years 2004 and 2005, employers can use a corporate bond rate.

[15]For employers, the group generally agreed that the following criteria should be considered: reduced regulation, low administrative costs, low contribution costs, high benefits for owners and officers, attractiveness to prospective employees, designs that are helpful in retaining current employees, designs with tax benefits to the company and owner, designs with contribution flexibility for the owners. For employees, the group generally agreed the following criteria should be considered: low costs and high returns, protection against investment risk, control over assets, portability of assets, protection against longevity risk, protection against inflation, tax benefits, psychological benefits of owning assets, simplicity and fairness for employees, and the adequacy of benefits provided under the proposal. From a public policy standpoint: effectiveness of the revenue dollars spent, and the degree to which savings are preserved for retirement rather than withdrawn earlier for other purposes. Proposals were also judged on how well they could be sold to Congress, employers and employees. They were also judged on how marketable they might be by financial institutions and benefits consultants.

[16]Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[17]On the contribution issue, the group explored the possibility that a combined 3 percent employer contribution for all employees to the defined benefit and defined contribution side of the plan would be sufficient to avoid nondiscrimination testing and top heavy rules.

[18]There was also support for providing a joint and survivor annuity on the 401(k) side, and for distributions as early as 59 ? years old on the defined benefit side to make it easier for workers to engage in phased retirement.

[19]The chief federal pension law is the Employee Retirement Income Security Act of 1974, often referred to as ERISA.

[20]As explained by the staff of the Joint Economic Committee in 2003 (See reference at the end), the full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent (for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets (i.e., the average fair market value over a period of years). However, the full funding limit may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limit may be based on projected true benefits including future salary increases. The full funding limit based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter, but is slated to be reinstated in plan years beginning in 2010. Thus. in 2004 and thereafter, until 2010, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets, as described above. Reference: "Present Law and Background Relating to the Funding Rules For Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation (PBGC)," Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and

Means on April 30, 2003, prepared by the Staff of the Joint Committee on Taxation, April 29, 2003.

[21]Traditional pension plans have to make up unfunded balances, according to descriptions prepared by the staff of the Joint Committee on Taxation in April 29, 2003 (See reference at the end), there are two categories of old unfunded liabilities (those that occurred prior to the plan year just ended). The employer has to calculate a current contribution required to amortize the unfunded liability for each of these two categories. The first amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments until fully amortized over a fixed period of 18 plan years, beginning with the first plan year that starts after December 31, 1987. The second amount is, in general, the amount needed to amortize the additional old unfunded liability over a period of 12 years, beginning with the first plan year that starts after December 31, 1994. In addition, plans have to make a contribution for any new unfunded liability that occurs in the year just ended. If the plan is less than 60 percent funded, the employer must contribute 30 percent of the new unfunded liability into the plan. The applicable percentage decreases by .40 of one percentage point for each percentage point by which the plan's current liability percentage exceeds 60 percent. Reference: ("Present Law and Background Relating to the Funding Rules For Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation (PBGC)," Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on April 30, 2003, prepared by the Staff of the Joint Committee on Taxation, April 29, 2003.

[22]Making the past service credit available to all employees would be deemed to satisfy the nondiscrimination requirements.

[23]However, if the plan is a profit-sharing, 401(k) or stock purchase plan, current law states the plan is not required to offer an annuity provided the spouse receives 100 percent of the account balance of the employee dies while covered by the plan. The law also states that if the plan does not offer an annuity and the employee does not die while covered by the plan, the employee can withdraw the account balance as a lump sum or other non-annuity payment without spousal consent when the employee leaves the plan.

[24]Elective contributions are contributions voluntarily made by employees into a retirement savings plan or pension plan.

[25]Under one safe harbor, the nondiscrimination test would be satisfied if the employer contributed 100 percent of an employee's contribution up to 3 percent of compensation and 50 percent an employee's contribution up to an additional 2 percent of compensation.

[26]The calculation for lump sums in all defined benefit plans occurs though a two-step process. This process presents special issues, however, when the plan in question is not a traditional defined benefit plan but is, instead, a plan whose benefit is an account balance. Several courts have held that the above-described procedure must be used to determine lump sum values for cash balance plans. The manner in which this is done is to credit interest through an employee's retirement age, convert the resulting retirement-age balance to an annuity, and then determine the present value of that annuity. Generally speaking, if the plan's crediting rate is higher than the statutory benchmark interest rate, the lump sum amount will be higher than the participant's balance in his account. Thus, a cash balance plan is not permitted to pay the account balance in these circumstances. This phenomenon has been called whip-saw.

[27]PBGC guarantees "basic benefits" earned before your plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants. PBGC does not guarantee health care, vacation pay, or severance pay.

[28]PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher if you retire after age 65 or if you are over age 65 and receiving benefits when the plan terminates.

[29]Underfunded single-employer plans pay an additional variable-rate premium of $9 for every $1,000 (or fraction thereof) of unfunded vested benefits. The proposed GAP would have the variable rate premium would be phased in for the first five years as follows: 20 percent for year 1, 40 percent for year 2, 60 percent for year 3, 80 percent for year 4 and 100 percent for year 5.

[30]The limits for contributions and benefits are within section 415 of the Internal Revenue Code. For defined contribution plans, the current annual contribution limit is currently $41,000 a year for 2004. For defined benefit plans, employers can contribute each year toward providing a maximum benefit at retirement of $165,000. However, employers face maximum tax deduction limits, too, that can limit the amount that can be contributed in any given year into defined benefit plans.

[31]The Tax Code sets the rules for converting the maximum allowable annuity into a lump sum for purposes of applying the maximum benefit limit applicable to defined benefit plans. Under that limit, defined benefit plans can pay no more than $165,000 a year as an annual retirement benefit. At the time the Working Group was meeting, the Tax Code required that plans use the 30-year Treasury rate for converting the annuity benefit into a lump sum for this purpose. Treasury has discontinued issuing 30-year bonds and the 30-year rate has declined considerably in recent years. This has meant that lump sums based on the 30-year interest rate assumption have been sharply higher than in the past.

[32]In fact, Congress in April 2004 passed a law to temporarily replace the 30-year Treasury rate with a 5.5 percent interest rate for two years (2004 and 2005) for purposes of calculating the maximum defined benefit limit.

[33]Nondiscrimination testing is required under the Tax Code to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is the Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[34]Plans are top heavy when key employees amass benefits greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an officer of the employer who received more than $130,000 (adjusted for cost of living) in compensation from the employer, (2) a 5 percent owners of the employer, or (3) a one percent owner who received more than $150,000.

[35]The name “cross-testing” refers to the rationale for these rules. The rationale is as follows: the present value of annual accruals in traditional defined benefit plans is larger for an older employee than a younger employee. For example, if a 25-year old employee and a 60-year old employee are each promised an annuity benefit of $1 at age 65, the employer must make a larger contribution for the older employee than for the younger employee because there will be less time for the contribution to earn interest. Treasury Regulations permit a defined contribution plan to test an allocation to an employee’s account as if it were a defined benefit with a present value equal to the contribution. Thus, the contribution is “cross-tested” as if it were a benefit under a defined benefit plan.

[36]The maximum contribution, however, is limited to $41,000 annually, under section 415 of the Internal Revenue Code.

[37]Current treasury regulations permit some plans to use new comparability testing methods only if they provide a 5% “gateway” contribution for all plan participants.

[38]Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[39]In some cases, it required some older workers to work several years before the balance in their cash balance account rose from the initial balance in the account at the time of the transition. This period in which no new benefits were added has been described as a period of wear away.

[40]The Working Group also discussed whether or not an employer should be required to wait two years after terminating a traditional defined benefit plan before being allowed to start a GAP. The members disagreed on this suggestion, with some noting that employers might instead terminated a defined benefit plan and adopt a defined contribution plan.

[41]The chief federal pension law is the Employee Retirement Income Security Act of 1974, often referred to as ERISA.

[42]The past service credit would be calculated by adding one-seventh of the past service career average compensation to the employee’s current compensation. For example, if an employee has always earned $20,000 per year and is entitled to 14 years of past service, the employee will be treated as earning $60,000 for the first X years of the plan for purposes of calculating the contribution. In this example, the employer could decide that only 50 percent past service credit is given, so the employee would only be deemed to earn $40,000 for those years. An employee who leaves before the full 7-year amortization period will only received the accrued past service credit that has vested on termination date. The reason for this is that, if pension benefits are viewed as deferred wages, the benefits earned after he plan is in effect are part of the bargained for package, but past service credit would be a windfall. Seven years of service for full accrual would encourage employees to give past service credit as a retention device.

[43]For example, an employer can tell an employee that his or her benefit at 65 was increased by 3percent, which translates into an additional accrual on this year’s salary equal to, for example, 1 percent.

[44]If a POPP were terminated and fully funded, the employer would have the option of keeping the plan and paying out benefits when due or transferring the benefit obligations and assets to the PBGC. If the employer transfers the benefit obligation and assets to the PBGC, annuitization would no longer be required, as PBGC would pay the benefit guaranteed under its authority, and lump sums would no longer be allowed.

[45]PBGC guarantees "basic benefits" earned before your plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants. PBGC does not guarantee health care, vacation pay, or severance pay.

[46]PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher if you retire after age 65 or if you are over age 65 and receiving benefits when the plan ends.

[47]Underfunded single-employer plans pay an additional variable-rate premium of $9 for every $1,000 (or fraction thereof) of unfunded vested benefits. The proposed POPP would have the variable rate would be phased in for the first five years as follows: 20 percent for year 1, 40 percent for year 2, 60 percent for year 3, 80 percent for year 4 and 100 percent for year 5.

[48]The plan could use cross-testing, permitted disparity and any other formulas permitted under Section 401(a) (4).

[49]A plan is top heavy when key employees amass benefits greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an officer of the employer who received more than $130,000 (adjusted for cost of living) in compensation from the employer, (2) a 5 percent owners of the employer, or (3) a one percent owner who received more than $150,000.

[50]Highly compensated employees are those who earn at least $90,000 a year.

[51]Under the Tax Code plans that meet the minimum contribution requirements of a safe harbor plan to avoid nondiscrimination testing must still also fall within the bounds of permitted disparity.

[52]The accrual rate is the percentage of final salary or final average salary which builds up for each year of service or membership of a defined benefit plan. For example, the plan may specify a retirement benefit of 1.5 per cent of final average salary for each year of service. The annual accrual rate, therefore, is 1.5 per cent (of final average salary). Can also be referred to as benefit scale.

[53]If the DB-K has a cash balance plan instead of a traditional defined benefit plan, the plan would require a 2 percent minimum contribution for workers under age 30, 4 percent for workers ages 30 to 40, 6 percent for workers ages 40 to 50, and 8 percent for those over age 50. Or, the plan could have a safe harbor if there is a combined 5 percent of pay contributed to both the defined benefit and defined contribution side of the plan.

[54]This alternative would provide a safe harbor from nondiscrimination testing for plans where the employer contributed 2 percent for employees under age 30, 4 percent for employees age 31 to 39, 6 percent for employees 40 to 49, and 8 percent for employees 50 and over.

[55]It has been suggested that IRS Notice 96-8 makes it difficult to provide a rate of return higher than the Treasury rate for employee contributions in a defined benefit plan. Since employees can get a higher return in their 401(k) plans, they would have little incentive

to voluntarily contribute to a DB-K plan if the return were going to be less. This could be done if policymakers clarified that Section 411(a)(7)(A)(i) of the Internal Revenue Code would apply to DB-K plans and, thus, allow the defined benefit plan to provide a market rate of return.

[56]In the Economic Growth Tax Relief and Reconciliation Act of 2001 (EGTRRA), Section 25B provides for a tax credit to match contributions from low-income employees into a defined contribution plan. The DB-K Plus proposal would make these credits available for a tax credit match for employee contributions to the defined benefit side of the DB-K Plus plan.

[57]The group also considered an approach that would guarantee only those benefits that had been in place for at least 10 years. The group also considered an approach that would set higher premiums for insurance from the Pension Benefit Guaranty Corporation (PBGC) for plans that have higher allocations to equities. Typically equities, over time, earn more than bonds; however, earnings can be very volatile. Reducing the equity exposure would reduce volatility in the pension funding obligation, a key employer concern that was identified by the group as impeding the implementation of defined benefit plans.

[58]The Secure Assets for Employees Plan Act was numbered H.R. 1656 and introduced in the House of Representatives on May 16, 1997.

[59]In the case of a SAFE Trust, the employer would be liable for additional contributions in years when returns in participant account did not earn 5 percent. SAFE plans would not be insured by the Pension Benefit Guaranty Corporation.

[60]Employers would fund the plan with contributions of 1, 2 or 3 percent of pay for each year they worked. In lean years the corporation could scale back the contribution to 1 or 2 percent. Individuals could also reap higher benefits than the minimum 5 percent return on funds in their accounts of the investments performed better than 5 percent.

[61]One objection to the SAFE plan was that its past service provision made it too rich for an IRA.

[62]Employees would be credited with either 1 percent or 2 percent of their salary for each year that worked, with 3 percent possible for the first five years of the plan.

[63]In the case of a SMART Trust, the employer would be liable for additional contributions in years when returns in participant accounts did not earn 5 percent. The employer who chose the SMART Trust would pay reduced premiums to the Pension Benefit Guaranty Corporation, which would guaranty the minimum benefit for the Trust. SMART Annuity plans would not pay a premium and the benefit would not be guaranteed by PBGC.

[64]One objection to the SMART plan was that it did not relax nondiscrimination rules, but simply provided a safe harbor.

[65]The group was asked to consider ways to solve the age-discrimination issues and the problems associated with whipsaw, which is a situation where an employee can get a benefit after leaving an employer that is higher than the employee's account balance.

[66]The Individual Advantage Plan was developed as a way to deal with cash balance conversions, but was also touted as a way for new plans to deal with older workers. One member said that he doubted anyone would start up a new plan that gave such a choice.

Questions & Ideas

Questions and Ideas from the National Policy Forum Working Group I

The Conversation on Coverage held a National Policy Forum on the proposals from this Working Group and others at the National Press Club on July 22, 2004. As part of that forum, people attending were invited to participate in break-out sessions to discuss the GAP and POPP proposals put forth by Working Group I. This section summarizes some of the questions, comments and suggestions addressed during the break-out session.

Many members of the Working Group were present to respond to questions and to take comments for the upcoming refinement and implementation phases of the Conversation on Coverage. Some of the responses below expand on comments made at the break-out session in order to provide background and context. It should be noted that while the Working Group spent a year on developing these proposals, this was a brief opportunity for those attending the conference to comment on them. Except for those on Working Group I, this was the first time the proposals were made public. The members of the other two Working Groups, for example, had not seen the proposals prior to the National Policy Forum. Those attending were invited to submit questions by card. Unfortunately, the group was unable to address all the questions submitted. A list of the questions that were not read for a response can be found in the footnote to this sentence. These questions will be looked at in the refinement and implementation phase.

Questions and Answers

Q. Is funding fixed on both the GAP and POPP – that is, are the assumptions used to calculate contributions specified? What happens if investment returns are higher or lower than the plans require?

A. Yes, the funding is fixed for both proposals. In the case of POPP, the contributions are higher than what would be required under current law for the same level of benefits because the funding assumptions are conservative. By specifying that the return on the accounts will be five percent, it will be easier for financial institutions to assure employers that they can meet that goal. It is expected that financial institutions will respond to POPP by offering products that can meet the five percent return. POPP allows employers to average performance over a ten-year period to smooth the results. Losses are made up over a five-year period. In the case of both POPP and GAP, plans are likely to use stable value types of investments, which are investments designed to produce a guaranteed rate of return, such as five percent. Some of them, however, can be variable tied to an index to match a similar guarantee in either POPP or GAP.

Q. Are there design elements in these plans that could be adopted by existing defined benefit plans to address problems in funding that they face?

A. The proposals that were developed by the Working Group were not designed to fix problems of existing defined benefit plans. They were, instead, designed to encourage those employers without a defined benefit plan to offer one of the two new proposed plans as a way of providing a plan that has a guaranteed benefit.

Q. Did the members of the Working Group consider that companies without a defined benefit plan might not want to assume the risk associated with the two proposals because the potential benefit to the

employer (providing a plan with a guaranteed benefit) was outweighed by the level of risk that would come with adopting the plan?

A. When members of the Working Group were designing both GAP and POPP, it was done partly with an understanding that employers would be able to transfer much of the risk for the guaranteed return to financial institutions. The risk would not be formally transferred. However, it is expected that financial institutions will offer employers products in which the plan can invest, and these products will provide the required return on assets that the plan specifies. To the extent employers are able to find the products that are tailored to meet the requirements of these plans – such as guaranteed interest contracts – the employer will have transferred most of the risk of managing the assets in the plan to a financial institution. Thus, the employer has a new benefit to attract and retain workers while minimizing the exposure of the company to market risks.

Q. POPP requires that the benefit be annuitized. GAP does not require the benefit to be annuitized. Did you consider requiring part of GAP to be annuitized? For both plans, would a requirement to annuitize present a problem for employers, since the private market is inefficient and such annuities might be expensive?

A. During the Working Group's discussions on GAP, there was a proposal to mandate that part of the benefit be paid as an annuity. The group did not reach agreement to support this approach. It was seen by those opposing it, as making GAP less attractive to employers. Opponents of a mandated annuity also noted that some retirees might not need an annuity because of other resources and, thus, might prefer a lump sum. Under the GAP proposal, employers could, of course, voluntarily offer an annuity option with GAP.

The Working Group also discussed whether institutions such as the Pension Benefit Guaranty Corporation should take on a new responsibility for paying out annuities for POPP, but the group did not reach agreement on this point. It was argued by those who supported this approach that it would be more cost effective if a single government institution took on the responsibility of paying annuities, the normal form of benefit for a defined benefit plan. This would avoid the likely higher cost of annuities that employers would pay if they bought insurance on their own.

Q. Why did you choose the GAP plan as a proposal instead of a floor offset cash balance plan?

A. The Working Group decided not to take on cash balance plan designs because of political and legal issues surrounding them. Instead, it reverse engineered a similar concept by taking a defined contribution type plan, the money purchase plan, and guaranteeing the return on balances in the plan.

Q. Will the design of the plan complicate your recommendation that it be insured by the PBGC?

A. Not necessarily. However, it will require legislation if either GAP and POPP are to be insured by the PBGC.

Q: What happens when a worker leaves a job before retirement and the sum is rolled over into a new vehicle?

A: POPP does not allow lump sum rollovers for early terminations. In the case of GAP, if a worker leaves a company with a GAP plan and asks for a lump sum rollover, he or she would no longer be able to earn the plan's guaranteed rate of return on the balance that was taken out.

Suggestions for Improving the Proposals:

Suggestion: You should allow a lump sum with the POPP. If a person leaves a job before retirement age, that person would be able to invest the balance and get a higher final benefit. It would also give them a chance to compensate for the fact that the plan is a career average benefit and not a final average pay benefit.

Response: Your suggestion regarding the lump sum would not likely lead to a higher benefit when a person is ready to retire. Here's why: if the balance that would have been taken out is instead left in the plan, it will continue to earn at the investment rate of return on which the plan operates. It does not simply sit there and remain the same balance. By contrast, if a person took the lump sum out and invested it and was able to earn the same rate of return as the plan, then the person would have the same retirement benefit. However, it is unlikely that a person who invests on his or her own would earn a higher return than the rate of return that the plan would earn over the intervening years. Thus, it is more likely that a person would have a higher benefit if he or she left it in the plan until retirement age.

Suggestion: Instead of having the PBGC insure the benefit for either POPP or GAP, why not just suspend interest credits if the company goes bankrupt or if it cannot catch up after an investment loss?

Response: There is a value to employees knowing that the plan is guaranteed by the PBGC. Because the funding restrictions are tight, the exposure for PBGC is reduced. Further, many in the Working Group conditioned their support of both POPP and GAP on their being insured by the PBGC.

Suggestion: Retirement plan proposals should be considered in terms of their relationship to the overall economy. The Conversation on Coverage should seek the input of financial economists on whether shifting more of the benefit package from wages to retirement benefits would result in additional costs. It would help to look at the experience of countries like Singapore, where saving is mandatory, and the United Kingdom, which supplements its social security program with a mandatory supplementary pension.

Response: Clearly, we need to research the economic implications of the proposals and the experiences of other retirement systems in the implementation phase of the Conversation on Coverage.

Suggestion: It would help if you were to provide examples of minimum funding rules and how the maximum deductible and accounting works for both POPP and GAP.

Response: The Working Group has worked out examples and they are included in this report as Appendix C (GAP) on page 36 and Appendix D (POPP) on page 44 of the report for Working Group I.

Suggestion: Why not recommend GAP for large employers?

Response: The GAP might be appropriate for larger employers. If the employer had a previously existing defined benefit plan, it would require terminating the plan and fully vesting the benefits of people who were in the plan. It was not the intent of the group to offer proposals that might have the effect of prompting employers with existing plans to terminate them. If, however, a larger employer currently has only a defined contribution plan, the Working Group generally agreed that such employers should be given the opportunity to add a GAP or POPP as a companion benefit to the defined contribution plan.

Suggestion: Why not design a plan that is divided into two parts to address the different needs of different age groups? One part would be a 401(k) for people in their 20s and 30s. Another part would be a defined benefit plan for people in their 40s and 50s. As people age at the firm, they could be transferred from the 401(k) part of the plan to the defined benefit part.

Response: The Working Group discussed such a proposal, but was unable to agree on this approach. Of course, an employer could have both types of plans, although that is not likely to happen at small- to mid-sized businesses.

Suggestion: How do you get around the paperwork hassles for smaller employers, along with the costs of having to hire actuaries?

Response: In the case of POPP, to the extent that the employer chooses a plan with simplified funding rules, conservative assumptions, published tables, and to the extent that the financial institutions provide the investment products to match the guaranteed return or benefit, the employer would not have to employ an actuary. The GAP plan, however, would require an actuary.

Suggestion: The two proposals do not represent new ideas, but appear to be different versions of the deferred annuity plan whereby the employer buys a piece of an annuity each year from a responsible insurance company. Why not add a deferred annuity option to an existing 401(k) plan?

Response: One could, of course, add an annuity option to an existing 401(k) plan. As for the proposals reflecting prior ideas, in some sense there are no new ideas in this area. So, it is no surprise that some proposals are "back to the future."

Questions Submitted on Cards:

The following questions were submitted on cards, but were not specifically addressed during the break-out session:

What can be done to continue coverage of workers in existing defined benefit plans, especially in light of freezes, terminations, and closing of participation to new workers?

How would you avoid the cash balance transition issue in converting a final pay defined benefit plan to a POPP?

Do you envision direct rollovers between POPP plans?

It seems to me that the funding rules and methods assume that conservative funding with existing rules works. Are you assuming that the maximum deductible limits go away?

For companies subject to Financial Accounting Standard 87 or international accounting rules, did you evaluate what the difference would be between the POPP funding and the accounting charge?

In the GAP, do you need to buy an annuity from an insurance company?

So long as the environment is chaotic, do you think people out of the system will get in, even if there are new plans?

Does the Working Group think that nothing will be fixed unless employer risk is lowered? (Lower risk could mean risk sharing or investing more in bonds.)

Does the group think that lower employer risk means lower benefit levels?

Is there a basis for estimating the coverage increase each of the two plans, POPP and GAP?

Working Group One Members

All Working group members participated as individuals not as representatives of organizations.

The affiliations listed are those during the time that they participated on the Working Group, during the second stage of the Conversation on Coverage, from 2003-2004. Current affiliations (2005) are listed in parentheses.

Phyllis Borzi
Of Counsel
O'Donoghue & O'Donoghue, LLP
and
Research Professor
Department of Health Policy
School of Public Health & Health Services
George Washington University Medical Center

Ellen Bruce
Director, Pension Action Center
Gerontology Institute
University of Massachusetts Boston

David Certner
Director, Federal Affairs
AARP

Charles Cole
Retired
* Former Mobil Oil Human Resources Executive
* Former Chair & Member, PBGC Advisory Committee

Patricia Dilley
Professor of Law
University of Florida College of Law

Lynn Dudley
Vice President and Senior Counsel
American Benefits Council

Ron Gebhardtsbauer
Senior Pension Fellow
American Academy of Actuaries

Deene Goodlaw
Lecturer
Boalt Hall School of Law
* Formerly of Pillsbury, Winthrop LLP

Brian Graff
Executive Director
American Society of Pension Professionals and Actuaries

Nell Hennessy
President
Fiduciary Counselors, Inc.

Mike Johnston
North American Practice Leader
Retirement Practice
Hewitt Associates, LLC.

Melissa Kahn
Co-Chair
Vice President
MetLife

Judy Mazo
Senior Vice President/Director of Research
The Segal Company

Shaun O'Brien
Assistant Director, Public Policy
AFL-CIO

Robert Patrician
Research Economist
Communication Workers of America

Norman Stein
Co-Chair
Douglas Arant Professor of Law
University of Alabama School of Law