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• Options for Health Plan Choice

• Pension Choice: A Proven Formula for Success

• We're Going Electronic!

Is It Time to Give Employees a Choice on Retirement Plan Design?

by Jeffrey R. Kamenir, ASA

An employer sponsors a retirement plan to help employees replace a portion of their preretirement income and maintain their standard of living in retirement. From a business perspective, the retirement program needs to be affordable and attract and retain employees.

Because there is no one type of retirement plan design that will attract and retain the different types of employees in today's workforce, perhaps the time has come for employers to consider giving employees a choice on the type of plan in which to participate. Furthermore, in light of the recent uncertainty and volatility in the stock market, some employees who direct their retirement plan investments may no longer wish to have their benefits entirely dependent on their limited investment management skills. The underlying company objective of such a retirement design could be to spend approximately the same dollars as the current design while increasing overall employee satisfaction with the retirement plan design.

This article summarizes the characteristics of various types of retirement plan designs and discusses the steps and issues involved in giving employees a choice. (For a related article on pension plan choice, see page 8.)

Basic Plan Designs

Under all retirement plan designs, a simple equation applies: Contributions + Investment Return = Benefits.

For defined benefit (DB) plans, benefits are determined by a formula and the company makes contributions that are necessary to provide the promised benefits. If a DB plan performs extremely well on its investments, there may be times when the employer is not required to make any contributions. If investment performance is subpar, the plan participant generally will still receive promised benefits, but higher employer contributions will be necessary. The amount of contributions needed is also dependent on year-to-year changes in the participant data.

Traditional types of DB plan design formulas include "final average pay," "career average pay," and "dollar per year of service." The final average pay design automatically adjusts for inflation by applying the employee's most recent (and presumably highest) earnings to the entire service history, as opposed to the career average pay design, which takes into account a worker's entire earnings history. The dollar per year of service design is typically found in plans covering hourly workers whose pay does not differ as much as salaried employees.

A traditional DB plan formula produces a monthly pension benefit payable at an employee's retirement. Payment amounts may be limited by regulations, and minimum benefits may be required in certain circumstances. The amount may be reduced for commencing monthly benefits at earlier ages or if monthly benefits continue to a surviving spouse. In some cases, an employer subsidizes these reductions. The amount also may be increased after payments commence for cost-of-living adjustments. Some DB plans allow monthly pension benefits that would otherwise be payable (based on interest rates applicable at the time of distribution) to be converted into a one-time lump-sum payment that can be directly rolled over to an individual retirement arrangement or possibly another tax-qualified pension plan.

Under a defined contribution (DC) plan, contributions by the employer may be required or discretionary. Plans have the option of allowing employee contributions. Benefits are determined by the value of an individual employee's account balance, which is derived from contributions and earnings on the investments. There are no limits on how much an employee may receive in benefits nor are there any required minimum benefit levels; instead, limitations and minimums may apply only to the contributions made to the participant accounts. After making a contribution, an employer has no further obligation regarding the benefits, although it retains fiduciary responsibilities relating to the plan.

Traditional types of DC plan designs are:

- 401(k) plans, which give an employee the option to contribute a portion of pay on a pre-tax basis, subject to various possible regulatory restrictions. To encourage employee participation, a company typically will match a portion of employee contributions. Certain tax-exempt and governmental plan sponsors offer 403(b) or 457 plans (which are similar to 401(k) plans).

- Profit-sharing plans, which allow a company to decide on an annual basis the total amount to contribute to the plan and which provide a formula to determine the amount allocated to each employee.

- Money purchase plans, which require the employer to make a contribution each year to an account for the employee.

Most DC plans today offer the opportunity for the employee to be responsible for making investment decisions. As a result, an employer usually provides a wide variety of investment choices and investment education.

Characteristics of DB and DC Plans

The characteristics of a particular type of retirement plan design tend to influence a company's decision on whether to offer the plan to its employees. This chart summarizes the characteristics of traditional DC and DB designs. Hybrid DB and DC plan designs attempt to combine features from both types of traditional plan designs.

Traditional DB Plan Characteristics	Traditional DC Plan Characteristics
• Flexible funding with fluctuating costs	• Stable costs with limited funding flexibility in certain design types
• Employer assumes investment risk	• Employee assumes investment risk
• Benefits can be accurately predicted	• Benefits not accurately predictable due to a dependence on investment performance
• Benefit increases can be applied to entire career	• Past service benefit increases not possible
• Subsidized early retirement benefits possible	• Subsidized early retirement benefits not possible
• Plan benefits can be adjusted for inflation after retirement	• Inflation adjustment not possible
• Certain types of designs deliver benefits to older, long-service employees more efficiently	• Can provide better benefits to younger, short-service employees due to faster benefit accrual
• Not always fully funded	• Always fully funded
• Annual actuarial valuations and Pension Benefit Guaranty Corporation premiums required	• Allocations of contributions, forfeitures, and investment income required on daily, monthly, quarterly or annual basis
• No responsibility for investment education	• Major responsibility for investment education (if employees have choice of investments)
• Benefits paid as annuity, but lump sums can be offered at employment termination	• Benefits typically paid as lump sum
• Tax-efficient employee savings not possible	• Possible to provide tax-efficient employee savings (employee contributions can be made on pre-tax basis)

Hybrid Plan Designs

Plan designs over recent decades have evolved in both the DB and DC arena. These "hybrid" plans basically are DB plans that have some DC plan characteristics, or DC plans with some DB plan characteristics (see sidebar, above).

The DB hybrids differ from traditional DB plan designs by producing a one-time lump-sum amount rather than a monthly lifetime payment; by so doing, such plans offer the attractiveness of DC plans in that they increase employee understanding of the plan. Hybrid DB plan designs include:

- A "cash balance" design, which, for example, might credit 5% of pay to an employee's account each year, with a guaranteed interest rate of 6% per year. The cash balance design, like the career average pay design, does not automatically adjust prior accruals for wage growth that might occur late in a worker's career.

- A "pension equity" design, which might resemble a traditional DB plan's final average pay formula but provides a relatively higher accrual percentage during earlier years of service and pays out the benefit in a lump sum. The pension equity design, like the final average pay design, automatically takes into account wage growth as an employee nears retirement.

The DC hybrid designs differ from traditional DC plans by weighting contribution levels in favor of older employees, similar to the benefit accrual pattern of a final average pay DB plan. For example, a "target benefit" plan formula looks similar to a final average pay formula. Contributions for each employee are determined based on the amount needed to provide the target benefit amount at retirement. A target benefit plan, like a money purchase plan, obligates a company to make a contribution each year.

Exhibit A

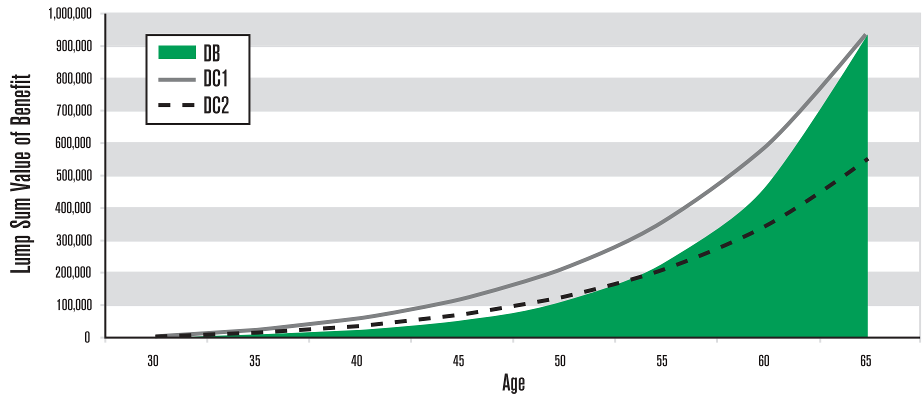


Exhibit A shows the accrual pattern for an employee hired at age 30 at $40,000 under a traditional DB Plan design with a benefit equal to 1.5% of final average pay per year of service (without subsidized early retirement), compared with accumulations under two traditional DC plan designs: DC1 plan with 8% of pay; and DC2 plan with 4.75% of pay. Assumptions: annual salary increases, 4.5%; annual investment returns, 8%; DB plan lump-sum values based on 1983 GATT mortality and interest rate of 5.78%.

The DB and DC1 plans will have equivalent employer costs (8% per year) and benefits only if the employee remains active through age 65. If the employee terminates earlier, the DC1 plan will cost more because greater benefits are provided.

Employer costs for the DB and DC2 plan designs will be about equal based on pre-65 termination assumptions of 20% at age 35, 15% at age 40, 10% at age 45, 5% at age 50, and 0% after age 50. But the DC2 plan provides greater benefits for younger terminees, while the DB plan will provide greater benefits for older terminees.

Offering Retirement Plan Choice

Converting to a retirement plan design with employee choice makes the most sense for a company that currently makes contributions to either a DB plan only or a DC plan only. Following the redesign, the company could in theory contribute approximately the same amount of money into the participant's plan of choice and increase overall employee satisfaction. A company that currently contributes to both a DB and a DC plan for the same employees could conduct a comprehensive review of coordinated plan design to consider possible areas where employee choice could improve the delivery of the retirement benefits at the most efficient employer cost.

When contemplating the offering of retirement plan design choice, employers have numerous types of plans, features, and options from which to choose, including two entirely different benefit accrual patterns, one of which may be better suited to younger workers and the other better for older employees (see Exhibit A). Perhaps an employer wants to consider offering the choice of whether or not employees wish to take the investment risk on all of their retirement benefits.

One of the first steps a company should take is to determine its current annual retirement plan contribution requirements. Then, assuming the company wishes to keep costs at about the same level, it should analyze the plan design that will keep costs level, taking into account that younger employees are more likely to select a DC plan while older employees will likely opt for a DB plan.

All current employees would then be given the one-time choice of remaining in the existing DC plan (or DB plan) or transferring into the new DB plan (or DC plan). If the employee elects the new plan, all benefits earned to date remain in the current plan and all benefits related to future service accrue under the new plan. All new employees would be given a one-time choice of which plan to go into, the DB plan or the DC plan, after a waiting period of up to one year.

EXHIBIT B

COMPARISON OF TRADITIONAL DB PLAN TO TRADITIONAL DC PLAN BENEFIT ILLUSTRATIONS FOR NEW EMPLOYEE JOHN DOE

YOUR AGE ON 1/1/2001: 37

YOUR ESTIMATED COMPENSATION FOR THE CALENDAR YEAR 2001 $48,300

		ESTIMATED LUMP SUM PAYABLE AT DATE OF TERMINATION(DOT)*			
Date of Termination	Age at DOT	DB Plan	DC Plan Interest at 6% per year	DC Plan Interest at 7% per year	DC Plan Interest at 8% per year
1/1/2006	42	$13,545	$25,587	$26,019	$26,459
1/1/2011	47	$40,232	$62,941	$65,541	$68,275
1/1/2016	52	$99,282	$120,895	$129,017	$137,842
1/1/2021	57	$304,060	$211,444	$231,135	$253,242
1/1/2026	62	$588,815	$341,396	$383,064	$431,425
1/1/2029	65	$776,402	$445,352	$507,948	$582,078

*A compensation increase assumption of 5% per year was used to determine all estimated lump-sum amounts. Your annual DC Plan contribution is assumed to be 7.5% of pay. Your annual rate of return on your DC Plan contributions is assumed to be 6%, 7%, or 8% per year. Your estimated projected DB Plan monthly benefits are based on the formula 1.5%x(Final Average Pay)x(Years of Service). You are first eligible for DB Plan subsidized early retirement benefits at age 55. The assumptions used to convert your estimated projected DB Plan monthly benefits to a lump sum are the blended 1983 Group Annuity Mortality Table and an interest rate of 6%. Your actual DB Plan lump-sum amount would be based on interest rate and mortality assumptions in effect at the date of your distribution.

To illustrate, an employer might cover all employees under a 401(k) plan without matching company contributions. After a one-year waiting period following the date of hire, the employer would give each employee a one-time choice of participating in a final average pay DB Plan or receiving 401(k) matching contributions and/or profit-sharing plan contributions. This approach gives all employees the same opportunity to save money on a pre-tax basis in the 401(k) plan and then allows them to decide how they want company contributions to apply.

To help employees decide on an appropriate retirement plan design, the employer could use a model that shows which option offers the best benefits, given various assumptions (e.g., future salary increases, date of termination, DC plan investment return). Exhibit B provides an example of the results of a benefit illustration model. Offering choice with clear benefit illustrations can help to ensure that there are no “losers.”

One additional step may be required if a company offers employees a choice on retirement plan design: nondiscrimination testing. Testing might be necessary because all employees will not be covered under the same plan. But testing rules are flexible and might only be required once every three years, depending on the margin by which the nondiscrimination tests are passed.

Conclusion

Today at many companies, an employee has numerous choices to make on employee benefits. Companies interested in leading the way to appealing to as many employees as possible should consider offering each employee a choice on retirement plan design. Giving employees a choice can directly respond to individual workers’ needs and desires. Offering such an option also can serve as an important means for an employer to make the transition from one type of plan design to another.

Jeff Kamenir is a consulting actuary in Milliman’s Chicago office.

Options for Health Plan Choice

by Robert G. Cosway, FSA

Since the emergence of the "defined contribution" (DC) health plan concept about two years ago, very few employers have moved to define their contributions toward employee healthcare coverage and allow workers to choose a plan, either from the options offered by the employer or from the open health insurance market. Instead, the DC health concept has evolved into a new generation of "consumer-directed" or "consumer-driven" health plan models. These plans can be offered alongside an employer's existing benefit options or they might replace all existing options. Few, if any, mid- to large-sized employers have overhauled their entire health benefit program by enrolling all employees into these new types of arrangements, although a growing number of employers have offered such plans to their employees.

This article examines the "traditional" and consumer-driven health plan choices offered by employers, and provides some insights for employers in evaluating the costs of the new innovations in DC health plan designs.

Current Health Plan Offerings

Most mid- to large-sized employers offer their employees several health plan options, and unless and until an employer embraces an extreme version of DC health—where employees must purchase their insurance in the open market—this will continue. The choices might have different financing arrangements (insurance carrier, health maintenance organization (HMO), self-insured), but looking beyond the financing arrangement, the actual differences among plan options reveal that true choices offered to employees can be defined by three characteristics:

- *Covered Benefits*—Almost all health plan options cover a standard set of "medically necessary" benefits: inpatient hospital care, outpatient hospital care (emergency room, surgeries, etc.), physician services, ancillary services (laboratory, radiology, etc.), skilled nursing care, home health care, ambulance services, and prescription drugs.

  The differences between the covered benefits of two plans typically are relatively small when examining the total benefit packages. The differences often involve the level of coverage for preventive services, chiropractic services, alternative medicine benefits (acupuncture, naturopathy, massage therapy), infertility treatment, transplants, and mental health benefits. Variation between the covered benefits of two health plans may be limited by state and/or federal benefit mandates.

- *Allowed Providers and Limitations on Access*—Plan options vary in the employees' freedom to choose physicians. At one extreme, employees choose from a list of physicians, while at the other, they may see any doctor in the community. In between are preferred provider organizations (PPOs) and point-of-service (POS) plans that specify a list of physicians, but that also allow employees to seek care from other physicians by paying a higher portion of the cost. Plans also vary in how easily employees may access a particular healthcare provider. In some plans, participants may not see a specialist without a referral from a primary care gatekeeper; in others, they are free to see any physician within a network.

- *Out-of-Pocket Costs*—Employees' costs for each covered service are defined in many different ways. Under the "dollar copay" approach, a dollar amount is specified for each type of service (e.g., $10 for an office visit, $50 for an emergency room visit).

  Under the "deductible/coinsurance" approach, a plan might have a $500 deductible, an 80% / 20% coinsurance, and a $1,500 out-of-pocket limit. Such a feature requires the employee to pay the first $500 of plan benefits, the plan pays 80% of remaining charges, with the employee paying 20% until his or her expenditures reach $1,500, at which point the plan pays for all remaining costs.

  Some plans are hybrids of the copay and deductible/coinsurance approaches, featuring copays for certain services, such as office visits and emergency room, with remaining services subject to a deductible and coinsurance.

  Over the course of a year, the copay structure produces much smaller employee out-of-pocket costs than the deductible/coinsurance approach. Under the copay approach, the plan pays for most of the care, starting with the first service. The deductible/coinsurance approach requires the employee to pay for services until the deductible is reached. For employees with catastrophic healthcare costs, once the out-of-pocket limits have been reached, both the copay and the deductible/coinsurance structures essentially pay for 100% of healthcare costs.

Expanding Choices under Current Options

Regardless of any influences the DC health concept might have on the healthcare market, an employer can offer more healthcare coverage options to its employees, but doing so may not alter the fundamental choices available under the current plans. For example, an employer's current health plan offering might expand the available choices by adding a different set of HMO and PPO arrangements, possibly with a wider variety of cost-sharing amounts. But does doing so actually increase employee choice?

A new HMO offering usually would provide benefits similar to those in an existing HMO. The list of physicians available through the HMO also could have a wide overlap. An exception to this duplication would be areas with staff model HMOs, which limit access to the physicians only on staff. Adding an HMO with different copays does increase choice, but on a somewhat limited basis as the employee can choose a $5 or $20 office visit copay with comparable differences in copays for other services.

For the new PPO, it is likely that the covered benefits and providers will be fairly similar to an employer's current PPO offering. The cost-sharing amount, however, can be a significant difference, ranging from a small or no deductible and a 90% plan coinsurance amount, to a higher deductible and 70% - 80% coinsurance feature.

DC Health Plans

Two goals of DC approaches were to get employers out of the business of choosing health care options for their employees, and to fix the amount that employers pay for health coverage for their employees.

There has been a wide variety of emerging innovations under the DC umbrella. None of them works directly toward achieving the first goal. Employers are offering additional options, including new consumer-directed health plans, but do not appear to be dropping the overall responsibility for plan administration and design. Employers might rethink this approach if laws are enacted to allow employees to sue their employers for health plan design issues.

With respect to the second goal, employers are always looking to control their contributions toward health care. Most of their efforts have been extensions of previous flexible benefit approaches. Most large employers continue to self-insure a large portion of their healthcare, and self-insuring is inconsistent with the goal of completely fixing the employer's cost in advance. Under self-insurance, the employer cost isn't known until the end of the year when paid claims are known.

Consumer-Directed Health Plans

The DC health concept has spawned several new types of health plan innovations, each of which is designed to control the employer's cost while at the same time increase employee choice.

- *Spending accounts with high deductible plan*—The most popular of the new consumer driven plans is a variation on the medical savings account (MSA) concept. Such an arrangement sometimes is offered in conjunction with a cafeteria benefit plan. An employee receives a company-paid catastrophic PPO or indemnity plan. For a single employee, the deductible might be $2,000, with the employer paying 100% of in-network costs over this amount. Each employee also has an employer-funded medical spending account, with an annual employer contribution of perhaps $1,000 for a single employee. Unspent amounts can be rolled over from year to year. Under current tax law, the account must be forfeited upon employment termination, but Congress has been considering changes to make the amounts portable. This design is intended to make employees feel like they are spending their own money when purchasing healthcare.

  This design offers significantly different characteristics from the current traditional health plan offerings. The spending account usually covers benefits not covered by traditional plans, and preventive benefits are often covered in full. Employees are free to see any provider, but must usually see network providers to receive the preferred level of PPO benefits. In addition, the copay structure is significantly different from either HMO or PPO/indemnity plans.

- *Individually chosen copay plans*—Another approach to increasing individual choice is to allow employees to select their copay levels for a wide range of benefits. For example, employees could choose their copays for office visits, emergency room, etc. Considering the different combinations, offering this approach can result in thousands of different possible benefit plan designs. These plans are very similar to existing HMO plans, except that employees are able to tailor the plan to their individual needs.

- *Individually chosen provider network*—Under these plans, employees select an individualized provider network in advance, with a choice of providers for a variety of specialties. Each provider has a per month price tag. The employee's total cost is based on the total price tags of the providers chosen. These plans are also similar to existing HMO plans, except the employee chooses a very limited network.

- *Episodes of care indemnity plan*—Under this approach, when a member has a particular disease or diagnosis, the plan determines a case rate for the treatment of those services. This amount is paid to the employee, who is then free to shop between different providers or different methods of treatment. This design is significantly different from current designs. Members are free to see any provider, but must pay any amount that exceeds the plan's payment for the treatment.

Evaluating the New Plan Designs

In general, allowing increased employee choice among health plan options can increase the total cost of the health benefit program, largely due to the natural tendency for individuals to select a plan in their own self-interest. The selection issue arises, for example, where an employee who can reasonably predict a significant need for healthcare services opts for an HMO with small copays for each service over an indemnity plan that features a $500 deductible and coinsurance for each service. Similarly, employees who know or suspect that they will need specialized heart care services will choose a plan that includes in its network a highly regarded cardiac care facility.

The biggest determining selection factor, however, usually is the overall cost of the option and the portion of that cost that is passed on to the employee through monthly contribution requirements (i.e., premiums). Most employers find that the lowest-cost option will attract the healthiest employees, particularly if there is a sharp price difference between the highest- and lowest-cost option. Often, only the sickest employees are willing to pay a significantly higher amount than the lowest-cost option.

Selection problems, however, can be minimized if the employer replaces all existing options with a single new plan design. This is a risky strategy because most of the new consumer-directed plans have not been fully tested and neither the employers nor the program carriers have enough experience to fully evaluate the performance.

With regard to the currently, most widely discussed consumer-directed health plan option, the success of the spending account with high deductible plans will depend on several assumptions that have yet to be validated by experience:

- Will the theory behind the spending account with high deductible structure—that employees will behave as though they are spending their own money—bear out? While the money can be carried over from year to year, it is not portable when the employee leaves. As a result, an employee planning to change jobs will likely spend it more rapidly.

- How should the employer set its contribution to the spending account so that the total employer cost, including the cost of the high deductible plan, will equal or be less than the cost of traditional benefits? Although actuaries have expertise in estimating the cost of stand-alone high-deductible plans, whether those assumptions will reasonably apply to plans with a spending account to help pay the costs before the deductible remains unknown.

- How much from the spending accounts might revert to employers upon an employee's termination of employment? Although some amounts likely will revert, an employer probably should not assume so when budgeting future healthcare costs.

Conclusion

Employers do not necessarily need to make fundamental changes to their flexible benefit structures or adopt one of the new consumer-directed plans to limit the cost of providing health benefits. Instead, cost reductions can be achieved by increasing the portion of the cost for the various options that must be paid for by employees through monthly premiums. Introducing new consumer-directed options may minimize the adverse reactions to increased employee contributions, but it is not clear yet whether the arrangements will have a fundamental impact on employer costs by bringing more consumer pressure to bear on healthcare purchasing decisions.

The new consumer-directed plan designs offer innovative approaches to health care. Employers might want to approach these new plans cautiously and await reliable data on whether they can be successfully applied to larger workforce populations.

Bob Cosway is a consulting actuary in Milliman's San Diego office.

Pension Choice: A Proven Formula for Success

by Richard E. Berger, FSA

An employer contemplating the switch from a traditional defined benefit (DB) plan to a different type of retirement program faces many challenges. Along with plan design, cost, administrative, and other issues, an employer will have to consider the effects the change will have on participants, in terms of both their expectations and their finances. Allowing plan participants the choice of remaining under the current pension formula or shifting to a new retirement benefit formula may go a long way toward addressing these concerns.

This article examines the steps plan sponsors should take to ensure a successful transition from a traditional DB plan formula to a new formula. Although a change to a "cash balance" DB plan formula is described, the basic elements would apply to an employer making the transition to other types of retirement plans. For a related discussion on giving employees a choice from among various types of retirement plan designs, see the article on page 1.

Out with the Old, In with the New

The choice movement is part of the long-term shift from traditional "final average pay" DB plans. The new option, in many cases, is a cash balance formula, but choice can also offer the opportunity to switch to a defined contribution (DC) plan. In some instances, the choice of a retirement plan formula is being offered in response to negative press reports on high-profile companies' cash balance conversions, which have drawn the ire of participants and the attention of Congress. Some claimed that cash balance conversions violated the Age Discrimination in Employment Act (ADEA) by providing lesser benefits for older employees in certain situations.

Choice offers dual retirement benefit formulas—the preconversion, traditional DB plan formula and the new, cash balance DB plan formula—to current participants. The new formula typically covers all new participants, while current participants choose between the old and new formulas. Choice is normally offered for a short time period and the participant's decision is irrevocable. Choice is an attractive alternative to covering all current employees under an offering of the "greater of" the old and new formulas. Although applying the "greater of" approach might please everyone, it has the highest cost and takes the longest time to transition all employees to a single benefit formula.

The Road to a Successful Choice Program

Implementation of a successful choice program generally entails a number of key steps.

- The initial idea may come from the plan sponsor or its consultant and may be part of a change in overall compensation strategy. Choice might be inspired by the existence of a surplus in the traditional DB plan, which can be used in providing cash balance benefits instead of cash contributions to a DC plan.

- Turning the initial idea into a detailed program design is where the plan sponsor first will encounter the reality of implementing a program for a diverse set of plan participants. Because future participants will join the company with no knowledge of the former program, the new program can be designed from a clean slate, reflecting the sponsor's ultimate goals. The challenge here is to design a plan that is attractive to a sizable portion of the employer's current workforce while protecting participants who prefer the current program. The new program's initial impact will vary significantly, depending on each participant's situation. For example, individuals can be expected to react differently if they are: currently eligible for retirement; executives who are also covered under a nonqualified plan; in mid-career; or young employees.

  Less obvious, perhaps, but as or more important, is that the impact will vary over time; the cash balance design that looks good now to the 40-year-old worker might appear deficient when he or she contemplates retirement 15 years later.

- How does an employer evaluate the effects of the choice program? The traditional approach of performing projections for all employees and inspecting windfalls and shortfalls in benefits is time-consuming and fraught with unanswered questions. A better approach is to construct an interactive model of the plan design and evaluate its effects on the major distinct constituencies of the plan's population. Generally, significant divisions will be based on age, compensation, length of service, and executive status. By evaluating the projections from data on these key employees under varying economic scenarios and at a range of ages, identifying the shortcomings in the initial design can be accomplished quickly. The interactive model also allows the plan sponsor to grasp immediately the impact of key features of the new program and transition benefits, as well as the changing effects of the new plan design over time.

FIGURE 1

VALUES OF ALTERNATIVE FORMULAS

Participant Information

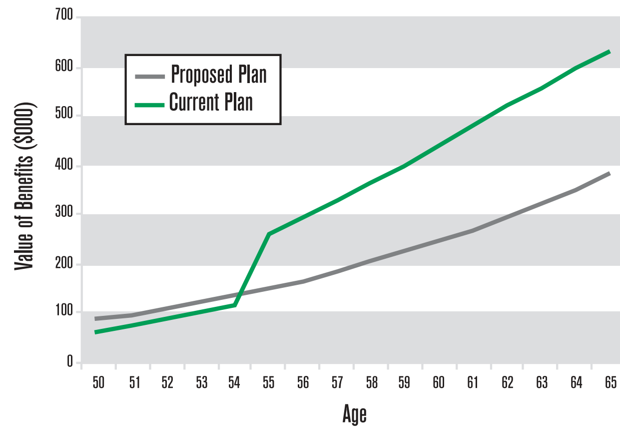
Current Age	45
Credited Service	10
Pensionable Pay	$55,000
Executive?	No

Plan Design Parameters

Retro CB credit	8%
Years of service for retro credit	10
Cash balance pay credit	8%
Cash balance interest credit	6%
Assumed bonus for CB formula	15%

Assumptions

Reflect 415 limits	Yes
Assumed salary increase	4.50%



Interactive model shows value of benefits under current and proposed plan formulas

Figure 1 shows a typical model that allows quick testing of alternative formulas on real participants. In the example shown, the current plan uses a final average pay formula and provides valuable early retirement benefits starting at age 55, while the proposed plan is a cash balance plan. One of the central transition problems facing the employer is how to cushion the loss of the enhanced early retirement benefits and make the cash balance formula more attractive. An interactive model speeds up testing of alternatives and provides instantaneous feedback on the effects of plan design changes.

- The evaluation of costs may include determining the effect on plan contributions and pension expense under the accounting rules. Cost calculations will vary depending on participants' choices, and a determination of the maximum cost may be necessary. Employers should bear in mind that plan costs may be much different in future years, as the new program covers a greater portion of the work force. The calculation of changing future costs may require the development of a sophisticated multi-year projection to allow for varying economic and demographic scenarios and the expected influx of participants covered under the new program.

- Nondiscrimination testing will be necessary because the plan population will consist of different groups under different formulas. Problems might arise immediately or only after the passage of many years. For example, if the choice is between a DB plan and a DC plan, eventually the DB plan may shrink below the legally allowable size (generally 50 participants, unless the plan is frozen).

- If the company approves the choice program, setting the timetable is critical. Implementing choice is a complex process with many parties involved: human resource managers, benefits consultants, information technologists, payroll administrators, and legal advisors. An employer should work backwards from the implementation date and constantly ask, "Is the time frame realistic?" Frequent meetings to coordinate efforts will be necessary to meet the program deadlines.

- Planning participant communications is crucial to the success of the program. Effective communications will reduce the likelihood that disgruntled participants will take legal action years down the road. Among the different methods of providing participant communications are: employee benefit statements and explanatory packages that include detailed projections under alternative scenarios, based on up-to-date participant data; interactive modeling that allows participants to run their own scenarios by themselves or in consultation with an investment advisor; and employee meetings that entail a formal presentation of the new program.

- Collecting participant elections is the final step directly involving employees. Employers should communicate a definite time period for participants to make the choice and a deadline for submission of elections. Plan sponsors also should instruct participants about the plan's default election if the deadline is missed.

- The plan sponsor must be ready for making the change as of the effective date. Benefits must be determined under the new formula as of that date. An employer also must comply with all of the legal requirements, including the drafting and adoption of new plan documents and the issuance of necessary notices to participants. Final nondiscrimination testing, based on actual participant elections, might be necessary. The plan sponsor must also be ready for administering the new plan on the effective date. In some cases, the investment strategy for plan assets may need to be changed, as liquidity needs change.

A Case in Point

To illustrate how an employer can successfully adopt a program that offers employees a choice of retirement plan formulas, consider the following Milliman case study.

A large retailer of consumer products offered a generous DB plan, with subsidized early retirement benefits. The plan was designed to reward long-service employees, and offered early retirement incentive programs from time to time and periodic retiree cost-of-living increases. A special formula applied to executives. The company also maintained a 401(k) plan that matched 50% of the first 5% of employee contributions.

The employer considered a new cash balance DB plan formula within the context of a major change in the overall corporate compensation package. The initial plan proposal included the following features:

- Retirement eligible employees would remain covered by the traditional DB plan's final average pay formula;
- All others would receive a cash balance plan formula that provided 8% pay credits, and the existing accrued benefits would be converted to an opening cash balance;
- Workers aged 40 and older would receive special pay credits that would put them in roughly the same position as if the cash balance plan had always existed;
- Eligibility for the new plan formula would be immediate, with 100% vesting;
- The matching employer contributions would be removed from the 401(k) plan; and
- Executives would be covered by the cash balance plan formula (i.e., the special formula applicable to this group would be eliminated).

Milliman constructed an interactive model for illustrating the impact of the new plan formula on participants, now and in the future, and helped the employer analyze the cash balance plan design's implications. Although the basic design was concluded to be sound, changes were needed to ensure a smooth transition. Based on data from the model, the employer determined that transition benefits, based on a sliding scale according to employees' ages, were necessary.

At this stage, the employer had not contemplated offering participants a choice of formulas (i.e., the choice between the old and new formulas). However, based on the concerns of the employer's legal advisors regarding possible age discrimination issues, choice was extended to employees aged 40 and older (i.e., the population covered by the ADEA). In addition, executives were given the same terms as other participants: if over age 40, they were offered the choice of cash balance or continuing their special formula.

Milliman projected annual accounting expense for the choice program over a 10-year period and compared it with projected expense under the current plan, reflecting the replacement of terminating employees with new participants covered under the cash balance formula. Milliman evaluated the new plan for compliance with nondiscrimination rules and determined that the design was feasible.

The final decision to implement the cash balance plan was made in November, with a period of opportunity for employees to elect which formula to be covered by extending from mid-February to March 31. With the program set to launch April 1, the timeframe was tight for having all of the administrative, legal, communications, and other issues resolved.

A phased communication program started immediately, with letters from management sent to all employees in December. These were followed up in February with an employee election kit (for employees offered a choice) with detailed benefit projections. Presentations were designed, employee-meeting leaders were trained, and employee meetings were held in the second half of February. The interactive model used for management decisions earlier in the process was modified for web-based application and access, a highly popular enhancement for both the employer and employees.

For those employees offered a choice, a four-page benefit statement detailed the projections of both formulas at different ages, based on two sets of salary increase and investment return scenarios. Those not offered a choice of formulas received statements showing their opening cash balance plan account balances. Statements prepared for executives showed benefits from both the qualified and nonqualified executive plans.

For most employees, the key determining factor in settling on a formula, when given a choice was: How long do I expect to be with the company? Those already eligible for early retirement or expecting to stay until they reached the plan's early retirement age favored the traditional final average pay DB plan formula. The others elected the cash balance plan. In the end, the "correctness" of each participant's decision will only be known in hindsight.

Conclusion

Programs giving employees a choice of retirement plan formulas are constantly evolving. As employers reassess their corporate objectives and strategies or confront changing demographics and workforce demands, the option for choice can be expected to become more prevalent. Many employers are converting their traditional DB plans to cash balance plans or 401(k)/profit-sharing plans; not-for-profit organizations are moving DB plans toward 403(b) tax-sheltered annuities; and public-sector employers are switching their DB plans toward money purchase defined contribution plans. At the same time, other employers are seeing the value of traditional DB plans and are exploring ways to maintain or adopt them.

A successful transition to what might be a new benefits era requires the design and implementation of a well thought out choice program. Offering choice to participants will increasingly become attractive to more employers as they update existing retirement programs. If handled properly, employees will welcome choice and be comfortable with their retirement decisions. The trail has been blazed and the path ahead is clear.

Rich Berger is a consulting actuary in Milliman's New York (Manhattan) office.

We're Going Electronic!

Don't forget! *Benefits Perspectives* is going electronic!

In the winter issue of *Benefits Perspectives*, we announced our decision to move the newsletter distribution from US mail to email. This move is in response to numerous requests from our readership to provide this publication electronically.

Originally, this spring issue was to be the final printed issue of *Benefits Perspectives*; however, as we are still receiving large numbers of email address updates daily, we are extending the deadline through one more issue. The summer issue will be the final printed issue of *Benefits Perspectives*. Distribution of all future issues of the newsletter will be sent via email unless you arrange with your Milliman consultant to have it mailed to you.

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For those who have already submitted email addresses, we will distribute the summer issue electronically (to verify that we have your correct email address).

We look forward to hearing from you, and hope you find this conversion to electronic format to be a welcome improvement to the distribution of *Benefits Perspectives*.

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Inquiries may be directed to:
Marsha Kuykendall, Editor
1301 Fifth Avenue, Suite 3800
Seattle, WA 98101-2605
(206) 624-7940
perspectives@milliman.com