

**A Symposium on Cash Balance Pensions:  
Background and Introduction**

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### Abstract

Here we provide an overview to a set of papers that analyze various facets of the shift to cash balance and other hybrid pension forms that has become controversial and widely discussed phenomenon in the evolution of private, employer-sponsored pensions in the United States. These new plans take on the characteristics of defined contribution plans from the perspective of workers but continue to be funded and operated as defined benefit plans from the perspective of plan sponsors. The shift to this new style of plans began in the mid 1980s but then took off and accelerated toward the end of the 1990s. This paper describes the context in which this shift in plan types being offered by employers took place because it helps to explain various features of these plans addressed in the remaining papers and the underlying reasons that employers have adopted the new plans. The latter part of this paper provides a very brief summary of the conclusions drawn from the remaining papers in the set.

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Almost from the beginning of the private employer-sponsored pension movement in the United States, employers have sponsored defined benefit and defined contribution plans. Until the mid-1980s the characteristics of these plans were distinctly different from each other. The former promised a benefit at a worker's retirement, a benefit paid as an annuity in most cases. The latter simply was a commitment on the part of the employer to make a periodic contribution to a plan in behalf of a worker and the ultimate benefit was an accumulation of contributions and returns on assets, generally paid as a lump sum when the worker terminated employment with the plan sponsor. In the mid-1980s, this distinction between these two types of plans began to erode when the first cash balance plan was established.

The cash balance plan was a hybrid plan. The benefit looked and operated like a defined contribution plan from the perspective of a worker. But it was funded and operated like a defined benefit plan from the perspective of the sponsor. The hybrid plan benefit was a notional account that the plan sponsor set up for a worker covered by the plan. Each year the account would be credited with a contribution based on the worker's pay. It would also earn interest credits based on the balance in the account. But the accounts were different than typical defined contribution accounts in that the funds behind the account were not invested directly in the worker's name. The account was a bookkeeping device that made it look like a defined contribution plan. The investment of the funds continued to be done in the same pooled manner that funds behind traditional defined benefit pensions had been invested. In most cases, when the worker terminates employment under one of these plans, the benefits are paid out in the form

of a lump sum although the plans do offer to pay the benefit in the form of an annuity to workers who want them paid in that fashion.

In the early 1990s, another form of hybrid pension came on the scene, a pension equity plan. These plans accumulate their benefits based on credits issued to workers based on their years of service under the plan. At any point in a worker's career under one of these plans, the points in the plan can be summed up and multiplied by current salary or average salary in recent years to determine the cash value of the benefit. Like cash balance plans, the benefits under these plans are always stated as an accumulated cash value and the benefits tend to be paid as lump sums when workers terminate employment under them.

Over the past few years, cash balance pension plans have been the subject of hundreds of news articles, several major court cases and significant legislative and regulatory wrangling in Washington. In most cases, issues like this play themselves out in the public policy arena after a couple of years, sometimes with legislative remedies being adopted but often not. Far from fading, the debate over hybrid pension plans has grown more intense in recent months.

When emotions surrounding an issue are at their peak, as they seem to be in this case, it is sometimes worthwhile to step back from the fray and to look carefully at what underlies the matters at hand. In the interest of doing this, the Research and Information Center at Watson Wyatt Worldwide has collected a set of analytical papers exploring various components of the shift from traditional defined benefit plans to new hybrid pension forms. These collected papers are posted as an "Electronic Symposium: The US Transition to Hybrid Pensions" on the web site of the Pension Research Council at the Wharton School at the University of Pennsylvania (<http://prc.wharton.upenn.edu/prc/prc.html>). Here we provide some context for the evolution of hybrid pensions and offer a brief overview to this set of papers.

## **The Environment in which the Shift to Hybrid Plans Has Evolved**

The hybrid phenomenon began in the United States in 1985, when Bank of America modified its traditional defined benefit plan and introduced the first cash balance plan. In its most recent annual *Pension Insurance Data Book*, the Pension Benefit Guaranty Corporation (PBGC) estimated that by the end of the 2000 plan year, 1,231 private defined benefit plans covering 7.2 million participants had been converted to a hybrid form. Among plans with 5,000 or more participants, more than 25 percent of plan participants were in a hybrid plan by the end of 2000 (PBGC, 5-6).

The shift to hybrid plans did not occur in a vacuum. The world of private pensions has changed considerably in recent years. Figure 1 shows that the private defined benefit system in the United States has been contracting significantly over the past couple of decades. The number of private plans insured by the PBGC peaked in 1985 at just over 112,000 plans. By 2002, the number of private insured plans had dropped to 31,000. Much of the contraction had occurred among smaller plan sponsors and so the decline in the number of private defined benefit plans was not directly reflected in the coverage of private sector workers as shown in Figure 1. From 1985 through 1999, the latest year for which PBGC has done an estimate, the share of private sector workers covered by a defined benefit pension dropped from just over 30 percent to 20 percent. The continuing decline in the number of plans since 1999 suggests that the trend in declining private pension coverage has continued as well.

*Figure 1 here*

There are several reasons why US defined benefit pension coverage has contracted in recent years. Some are related to developments on the regulatory front, as the administration of these plans has become more expensive compared to typical defined contribution plans. Others

have to do with the changing structure of business in the United States and the fact that certain types of business and workers may be better served by defined contribution than defined benefit plans. Yet others have to do with changing worker tastes in terms of the types of retirement plans they prefer as they advance through their careers. And finally, some have to do with the changing composition of the US population and workforce.

Not everyone has greeted the shift toward defined contribution plans as a desirable outcome. There are concerns that the success of defined contribution plans is much more dependent upon workers making right choices about participating in their employer-sponsored plans, saving adequately when they do, investing appropriately during their careers, preserving their retirement savings as they change jobs from time-to-time, and properly disposing of their assets during retirement in order to provide true retirement security over uncertain life expectancies.

In addition to these sets of issues, a larger set of macroeconomic and socio-demographic considerations underlies some of the evolution of the employer-based pensions system in the United States. Our society, like many others around the world, is aging because of changing demographic patterns that evolved during the twentieth century. In the future, we will have many more retirees in our society relative to working age adults than we have had historically. Our ability to support this growing retiree burden may strain our ability to continue to grow our economy, improve all of society's standard of living, and continue to do many of the other things we consider important in our highly dynamic market-based economy.

Recognition that the aging of our society will have significant economic ramifications drove the US Congress to adopt changes to the national Social Security pension system in 1983, changes that are now being implemented. Until recently, any worker who did not lay claim to

his or her Social Security benefit until reaching age 65 would get what is considered to be the “full benefit” provided by the system. Workers could retire earlier, as early as age 62, and could receive an actuarially reduced benefit, but full benefits were not payable until age 65. Workers who turned age 62 in 2000 could no longer claim full benefits at age 65. For this first group affected by the 1983 Social Security Amendments, workers had to wait until age 65 and two months to qualify for full benefits. Those reaching age 62 in 2001 will have to be age 65 and four months to receive full benefits. The age of eligibility for full benefits will continue to increase until it reaches age 66. Then, after a 12-year break, the eligibility age for full benefits will again begin to increase at a rate of two months per year until it reaches age 67.

Private sector employers are mindful of the increase in Social Security’s “normal retirement age” from at least a couple of perspectives. First of all, the same demographics facing the Social Security system are collectively facing the employer-based pension system in the United States. If our evolving demographics portend that Social Security will become more expensive in the future, then employer-sponsored pensions will as well. Second, Social Security benefits are a significant part of the retirement portfolio of many workers, and employers that sponsor pensions tend to design their plans around this foundation of our national retirement system.

The evolution of the US labor market has also prompted employers to modify their retirement programs in recent years. Figure 2 shows the historical growth rates in the US civilian labor force in the decades since the end of World War II. Typical workers in the United States enter the workforce in a career context during their early twenties. That means that the baby boom generation born between 1946 and 1965 started to feed the growth of the labor force in the mid-1960s and continued to do so into the late 1980s. Indeed, Figure 2 shows that during

the period when the baby boom generation entered the workforce, we had relatively high growth rates compared to the decades before and after their entry.

*Figure 2 here*

During the 1990s, the US economy grew significantly and by the middle of the decade, many employers were stressed in their ability to attract and retain the numbers of workers they felt they needed to continue to support and grow their business operations. Virtually everyone who was in a significant management position during the 1990s had spent most of their working life in a labor market that could be characterized as having surplus labor because of the growth effects that the baby boom had on the total supply of labor in this country. The tight labor markets of the 1990s were a new experience for almost all managers and led them to reconsider many of the things they had done during the earlier periods of surplus labor.

As we look to the future, some people are sanguine that there is an echo to the baby boom currently progressing through the educational system in the United States—a group of people as massive in numbers as the baby boom generation itself. There is no doubt that this will be an extremely rich natural resource for our society that will help secure our future, but it will not result in anywhere near the sort of growth in our labor supply that the baby boom did. There were two aspects of the baby boom generation's entry into the US labor market that will not be repeated when the group of people born as the echo to the baby boom comes into the labor market. In the case of the baby boom generation, they were much larger than the generation of people retiring from the labor market. From 1970 through 1985, the number of people ages 20 to 24, typical entry ages into the workforce, was twice as large as the number of people ages 60 to 64, typical retiring ages from the workforce. As the baby boomers entered the labor market, their sheer numbers resulted in labor market growth.

In addition to its size, the labor force behavior of the baby boom generation of women was important in explaining labor force growth rates from the late 1960s through the 1980s. In 2000, the baby boom generation of women was roughly age 35 through 55. Assuming that their mothers were some 30 years older than they were, on average, the baby boomers' mothers would have ranged in ages roughly 65 to 85 in 2000. Figure 3 shows that the baby boom women entered the labor market at much higher rates than their mothers had and that they stayed in the workforce at greater rates during their childbearing years. The labor force behavior of the baby boom women accentuated the effect that the size of the baby boom had on the labor force.

*Figure 3 here*

In 2003, the number of people ages 20 to 24 in the US economy is about 1.67 times the number of people ages 60 to 64. The leading edge of the baby boom echo is now entering the workforce. The generation that is ages 60 to 64, however, is relatively small because this group is comprised of people from the birth cohorts born just before the increase in fertility rates that resulted in the baby boom. By 2006, the leading edge of the baby boom will be turning 60 and the ranks of 60 to 64-year-olds will grow rapidly. By 2010, the number of people ages 20 to 24 will have dropped to 1.30 times the number of people ages 60 to 64. By 2020, this ratio will have dropped to 1.00. Not only is the age composition of our population very different today than it was from the 1960s through the 1980s, the increasing labor force participation rates of women as reflected in Figure 3 has come to a halt with the birth cohorts behind the baby boom generation.

The tight labor markets of the late 1990s have softened considerably since the beginning of the twenty-first century. This was initially due to the softening of the economy related to the slowdown of the economy in 2000 and the recession we entered in early 2001. Since the

economy has started to grow again in 2002, labor markets have remained soft due to what appears to be some structural shifting of manufacturing jobs from the United States to less developed economies. In the longer term, however, we should expect that economic demand will result in labor market demand that is much more akin to the late 1990s than the 1970s or 1980s. The underlying reason has to do with the voracious appetite of the American consumer combined with the slower growth in working age population that we anticipate in coming decades.

### **Retirement Policy, Retirement Behavior, and Economic Growth**

In all economies, including that of the United States, output growth is dependent on two crucial factors: the rate of growth in the labor force and the rate of improvement in worker productivity. The first of these is partly driven by demographics and partly driven by how we organize and operate the economy—including how we operate our retirement system. The second is driven by rates of improvement in human capital, the levels of physical and financial capital that workers have at their disposal, and technology. Many economists are concerned that the slower growth in the labor force in the future has the potential to slow the growth in our economy and the rate of improvement in standards of living.

Anyone who pays attention to political dialogue and public policy deliberations in the United States understands the sensitivity of our public discourse to economic slowdowns. When the economy shows signs of weakness, a combination of fiscal and monetary policy incentives are quickly brought to bear to stimulate economic activity and restore steady growth. Failure to achieve results has resulted in the replacement of several of the most senior politically appointed officials a variety of administrations running our federal government and contributed significantly to the de-election of more than one president over the past half century.

A growing and prosperous economy characterized by tight labor markets is one where the actual provision of goods and services that underlay an improving standard of living is being limited because there are inadequate labor resources to deliver on what consumers want and are willing to pay to acquire. If our demographics in the future portend that our labor markets may become tight again like they were in the late 1990s — or even tighter still — the implication is that slower labor force growth will inhibit economic growth and improving standards of living. For retirees, this may come to bear in the form of reduced retirement benefits and the lower consumption levels that will go along with them. For workers, this may come to bear in the form of higher tax rates to support a rapidly growing elderly population — tax rates that leave workers and their families with smaller disposable incomes than those enjoyed by prior generations.

For employers to satisfy the demands for their goods and services, the aging of the US population and tightening labor markets suggest businesses will have to find ways to keep workers somewhat later in their careers than they did in the heyday of surplus labor when the baby boomers were entering the labor markets. For elected officials whose own job security is dependent on a growing and thriving economy, keeping workers in the labor force until later in life may be the only way to achieve sustained robust economic growth. Both business and public policymakers share a common goal although the motivations behind their respective objectives will be very different.

The US Congress implicitly recognized the risks to our economic success in 1983 when it modified the national pension system to begin increasing the retirement age at which full Social Security benefits will be paid. The gradual increase in the age at which full benefits are paid (from age 65 to 67) began in 2000. When this is fully implemented, the benefit that will be payable to a worker retiring at age 62 will be 12.5 percent less than if the normal retirement age

under Social Security had been left at age 65. For any worker who aspires to the higher standard of living in retirement that applied prior to the increase in the retirement age, the incentive is clear—he or she has to work a bit longer to achieve that prior standard of retirement income.

One of the interesting elements of the increase in Social Security's normal retirement age is the widely different implications it has as an incentive to extend working careers across the earnings spectrum. This point is best explained by adapting an analysis developed by Olivia Mitchell and James Moore's study (Moore and Mitchell, 2000) that uses the *Health and Retirement Study* (HRS) being sponsored by the National Institute on Aging. The HRS was conducted on a representative sample of people between the ages of 51 and 61 in 1992 drawn from the general population. Sample members are being interviewed every two years.

Mitchell and Moore have used this data set to estimate the participating households' wealth levels. They include four classes of wealth in their calculations. These are: 1) net financial wealth, including saving, investments, business assets, and non-residential real estate less outstanding debt not related to housing; 2) net housing wealth, or the current market value of the residential housing less outstanding mortgage debt; 3) pension wealth, or the present value of employer-sponsored retirement benefits; and 4) the present value of Social Security benefits.

Table 1 has been derived from Mitchell and Moore's analysis. The derivation does not include housing wealth in the calculation of the wealth distributions because most homeowners do not sell their homes at retirement, or if they do, they tend to buy another one. Our definition of wealth in this case would include business assets and non-residential properties. We are interested in looking at assets in these folks' portfolio that can be expected to generate a stream of income that they can use to buy groceries, go to the movies, and so forth, during their retirement. The results are instructive.

*Table 1 here*

The people at the bottom end of the wealth distribution hold almost all of their wealth in the form of Social Security. Those people one-third of the way up the distribution still hold nearly two-thirds of their wealth in that way. Those two-thirds of the way up the distribution have a rough parity in their wealth holdings between Social Security, pensions, and other financial wealth. Those at the top of the wealth distribution have almost no dependence on Social Security. The retirement security risks associated with potential reductions in Social Security benefits are clearly not randomly distributed.

The implications of this distribution of relative wealth to support retirement consumption can best be understood in the context of the increase in the normal retirement age now underway in the US Social Security program. For people in the bottom 10 percent of the wealth distribution represented in the table, a 12.5 percent reduction in their Social Security benefits would represent roughly an 11.7 percent reduction in their retirement income resources because nearly 94 percent of all their retirement wealth, other than their homes, is tied up in Social Security. In the top 10 percent, on the other hand, the 12.5 percent Social Security benefit reduction would represent a 1.3 percent reduction in retirement resources. To the extent that policymakers are interested in encouraging workers to stay in the labor force longer, increases in retirement ages now being implemented will be less and less effective the higher up the earnings distribution a worker is located.

### **The Economics of Traditional Defined Benefit Pension Promises**

Most private sector defined benefit plans, up through the mid-1990s at least, were final average pay plans. These plans typically based benefits on average pay from near the end of the period working under the plan. The averaging period was typically three or five years. Figure 4

shows how a typical plan with this structure works. It helps to explain the financial incentives in these types of plans that encourage workers to exhibit certain kinds of behavior.

*Figure 4 here*

In this case we assume that a worker is hired at age 25 and accrues benefits as long as he or she serves under the plan. We also assume that this worker accrues real pay increases on a regular basis. The figure shows two different accrual patterns of benefits. The reason that these two patterns vary is because they are based on varying assumptions about when the worker terminates employment under the pension plan in question. The projected benefit assumes that the worker stays until retirement age and then claims a pension. The accumulated benefit assumes that the worker terminates employment at each age shown on the horizontal axis in the figure.

If the hypothetical worker in this case quits working for the employer who sponsors this plan at age 40, he or she will not be eligible for a benefit until reaching age 65. But the benefit that will be determined at that point will be based on the average pay the worker earned in the three or five years leading up to age 40. By contrast, the worker who continues to work under this plan until reaching age 55 (the age of early retirement eligibility) will qualify for a benefit based on average salary just before attaining age 55, and that average salary will generally be much higher than when he or she was just under age 40. The higher average wage in this latter case applies to all the years of service, including those between the ages of 25 and 40. For the worker who stays until immediate retirement eligibility under this plan, the value of the benefit at retirement based on service up to age 40 will be about three times that of the value of the benefit for the worker who terminates at age 40. The difference in the two benefits at age 40 is the

equivalent of a half year's pay. The difference in the two benefits at age 50 is nearly a full year's pay.

If an employer terminates a defined benefit plan, the potential effect for workers covered under the plan is virtually identical to that resulting from the worker terminating employment under the plan. The reason is that if the plan is terminated, under the law regulating pensions, benefits will be determined at retirement age based on the salary levels just before termination of the plan, not the termination of the worker's employment.

Economists have studied this phenomenon in defined benefit pensions and have observed that most employers face the opportunity to take substantial advantage of workers by either terminating employment shortly prior to their qualifying for benefits or by terminating the plan. Since most employers historically have not seized the opportunity to take advantage of the difference between the accumulated and the projected benefit, economists have characterized the situation in terms of an "implicit contract" between employer plan sponsors and participants.

In Figure 4, the accrued benefit under the plan increases dramatically nearly closing the gap between it and the projected benefit. This feature of typical traditional defined benefit plans reflects the early retirement incentives that are prevalent in most of these plans today. This step-up in benefits occurs because prior to age 55, a worker who terminates employment under the typical plan will not qualify for a benefit until reaching age 65, or will qualify for a benefit discounted for full actuarial reductions from age 65 back to termination or actual retirement date. In most plans, workers turning age 55 and qualifying for an immediate early retirement benefit are paid that benefit with very favorable actuarial reductions. This dramatic increase in pension wealth on the worker's 55<sup>th</sup> birthday — more than a year's pay in the example shown — provides a strong wealth incentive to encourage early retirement.

Early retirement subsidies might have been affordable and even desirable in an environment where there was surplus labor and few older workers. The environment in the late 1990s when the hybrid pension movement came into full blossom and what we face in the future is very different. It is clear that many employers can no longer afford to discard workers in their mid 50s who are still highly productive. Most employers can certainly no longer afford to subsidize them heavily to quit working when there are so many of them and so few younger workers to fill the vacancies they create when they retire.

Several of the papers included in this symposium refer to the “implicit contract” features of traditional defined benefit plans and the implications of the shift to hybrid plans for these features. The various analyses indicate that simply terminating a traditional defined benefit plan might be considered a reneging on this implicit contract from an economic perspective, even though it does not reflect an abrogation of legal requirements specified in ERISA. The analyses indicate that the various transition and grandfathering provisions that are common in hybrid pension transitions reflect sponsors’ attempts to honor expectations of workers even when they are not legally required.

### **Socio-Economic and Demographic Developments and the Move to Hybrid Pensions**

The papers in this collection have been authored by a number of prominent economic researchers analyzing various aspects of the US retirement system. The papers focus on the shift to hybrid pension plans within the context of issues that have been raised in the discussion above.

The first paper, *Cash Balance Pension Plan Conversions and the New Economy*, by Julia Lynn Coronado and Philip C. Copeland (2003) of the Federal Reserve Board of Governors in Washington, DC, analyzes the underlying influences behind companies’ decisions to convert from a traditional pension plans to hybrid plans. Coronado and Copeland looked at three

possible drivers: cutting costs by decreasing benefits, avoiding the reversion tax imposed on employers who terminate overfunded plans, and attracting and retaining employees.

Coronado and Copeland conclude that employers have not reduced overall benefits to employees through conversions to cash balance plans. Specifically, they examine whether a firm's projected benefit obligation (PBO) increased or decreased after a conversion. The data indicate that employers have not reduced the overall benefit provided to employees although some redistribution has occurred. For more than two thirds of their sample, pension liabilities increased upon conversion.

The authors find that some employers have likely used the conversion to a hybrid pension rather than a defined contribution plan to avoid the tax penalties. In the sample of plan conversions used for their study, however, they find that projected benefit obligations increased in the year after conversion for two-thirds of the cases studied. This, of course, would not be the case if a firm was simply shifting to a hybrid plan to protect assets from the federal excise tax. The authors even adjust the discount rates used for determining these obligations to make sure that plan sponsors were not manipulating the discount rate to hide benefit reductions and still concluded that the majority of firms increased their liabilities as they converted to hybrid plans.

Ultimately, Coronado and Copeland conclude that the move to cash balance is largely being motivated by the need to attract a more mobile workforce. To determine the impact of workforce trends on the decision to convert to cash balance plans, they look at labor market conditions across industries. They find that where employers tend to be competing against other firms that also offer defined benefit plans, there was a lower likelihood of conversion to a hybrid plan than where a firm was likely to be competing for labor against a defined contribution plan.

Industries with more mobile workers are associated with higher rates of hybrid plan offerings. Tighter labor markets also led to higher rates of conversions.

The second paper, *The Shift to Hybrid Pensions by US Employers: An Empirical Analysis of Actual Plan Conversions* by Sylvester J. Schieber (2003) of Watson Wyatt Worldwide, examines actual plan conversions to determine the cost implications for plan sponsors and the effects on plan participants. He finds that the shift to hybrid plans is largely about redistributing benefits more evenly among workers, not reducing overall costs or benefit levels except in one particular regard.

While it is definitely possible to save money in the shift from a traditional pension to a cash balance or other hybrid pension plan design, Schieber concludes that in reality, the typical company realizes little, if any, net cost savings when it shifts from a traditional pension to a hybrid plan design. Among the plans studied, average retirement plan costs were reduced by 1.4 percent during conversions. This estimate does not include any potential increases in worker mobility or other factors likely to arise under hybrid plans that would ultimately drive up plan sponsors' pension costs.

One area where benefits are clearly being curtailed in the shift to hybrid plans is the elimination of subsidies for early retirement, which typically augment benefits at around age 55. This shift is resulting in new incentives to work beyond early retirement ages. In some limited numbers of cases, sponsors have used the elimination of these benefits to generate cost savings in their pension plans. Most have plowed the savings from the elimination of these subsidies back into their plans.

For older workers with long tenures under traditional plans who were counting on these benefits, changing plan structures late in their careers can be particularly controversial. However,

the vast majority of plan sponsors (88 percent) have included transition benefits to minimize the effect of the transition for longer tenured workers. And, the closer a worker was to retirement and the longer the period of service before the plan conversion, the greater the transition protection offered by the plan sponsor.

Traditional plans have generally provided a tremendous advantage to a relatively small number of workers—those who spend most of their career with a single employer. Under traditional plans, workers might be employed under a number of traditional defined benefit plans during a mobile career, get significantly smaller benefits from traditional plans than workers covered by a comparable single career-long plan. Given Coronado and Copeland’s analysis, however, it is clear that many of the employers that have shifted to hybrid plans are competing for workers who are mobile and in high demand. Providing them pensions that offer minimal benefits is no longer an option. Schieber’s analysis clearly documents that hybrid pensions offer a more even distribution of benefits and a majority of workers fare better under the new plans.

Schieber also evaluates the controversial “wear away” phenomenon that sometimes arises in the conversion to hybrid plans. He compares it to provisions in the prior traditional plans that provided subsidized benefits to early retirees and then reduced them if workers extended their career beyond early retirement eligibility. This analysis shows that wear away has actually been ameliorated in the shift to hybrid plans although shifted forward in the career in most cases. The paper demonstrates that it is largely the elimination of these early retirement incentives that is at the heart of the shift to hybrid plans.

The third paper in this set, *Pension Plan Options: Preferences, Choices, and the Distribution of Benefits*, by Robert L. Clark (2003) from North Carolina State University, analyzes the trend toward hybrid pensions in the larger context of the shift toward defined

contribution plans occurring over the past two decades. Pension plans are an important part of the basic compensation package that US employers typically offer to workers. In a free labor market, workers find the firm and the compensation package that best fits their needs while companies use pensions to attract, motivate and retain individuals with certain desired employment characteristics. But over time, the environment in which workers are hired and compensated can change the type of plan that employers and workers find most desirable.

Clark investigates the relative benefits of defined contribution and defined benefit plans and the sorts of behaviors they are intended to motivate and workers' reactions to them. He explores the relationship between the implicit contract expectations of workers under their traditional plans and the explicit obligations employers have in accordance with the federal laws regulating plan operations. He raises the question of why there has been so much public consternation about the changing nature of the pension deal in the case of hybrid plans when a virtually identical set of shifts has been going on for at least 30 years as thousands of plan sponsors have terminated defined benefit plans and shifted to pure defined contribution plans. He notes that in the case of the shift to hybrid plans, most employers have not reneged on their "implicit contracts" in that they have provided substantial grandfathering and other transition subsidies for older, longer-tenured workers.

The author concludes that the impact of plan conversions cannot be determined by simply comparing the expected benefits under the old plan conditional on it continuing and the worker remaining with the firm. In considering the distributional effects of the conversion of a traditional pension to a hybrid plan, it is important to consider what might happen if the conversion was not made. On the plan sponsor side, possible outcomes include the termination of the plan with no new plan established, layoffs, or even bankruptcy of the company. On the

workers' side, a wide variety of contingencies often result in workers leaving jobs before retirement eligibility even at advanced ages and with substantial tenures.

In a fourth paper, *Possible Implications of Mandating Choice in Corporate Defined Benefit Plans*, Olivia S. Mitchell of the Wharton School, University of Pennsylvania, and Janemarie Mulvey of Watson Wyatt Worldwide (2003), offer some insights into the impact of mandating plan choice when an employer converts a traditional pension to a hybrid plan. The authors simulate the cost of conversions using different "choice" scenarios. They find that the direct costs of choice will depend heavily on employee expectations about how long they will stay with their current employer. In their simulations, the direct costs of choice appear relatively small, but this overlooks an indirect cost that also must be accounted for. This is the administrative burden of maintaining a separate and ongoing DB plan for a dwindling number of workers, while at the same time offering a new plan for those who switch. Added administrative costs due to choice could be quite large, and could lead to reductions in other components of compensation. In their terms, there is no "free lunch." Tradeoffs could be felt in the form of reduced wages, slower wage growth, cuts in other benefits, or even in plan termination as a worst-case scenario.

Since hybrid pension plans can help plan sponsors encourage older workers to continue working and delay retirement, Mitchell and Mulvey warn that recent court and legislative efforts to curtail hybrid plans could result in undesirable employment and retirement outcomes.

A final paper in the set, *Promoting Work at Older Ages: The Role of Hybrid Pension Plans in an Aging Population*, by Richard W. Johnson and Dr. Eugene Steuerle of the Urban Institute (2003), examines the growth in hybrid pension plans and their benefit structure within the context of national labor and retirement policy concerns. The authors closely examine

demographic data that documents how population aging is transforming the labor market and how the labor force will likely change in the near future if current participation rates persist. They then consider how improvements over time in health status and declines in the physical demands of work increase work capacity at older ages and how retirement incentives differ between hybrid plans and traditional defined benefit plans.

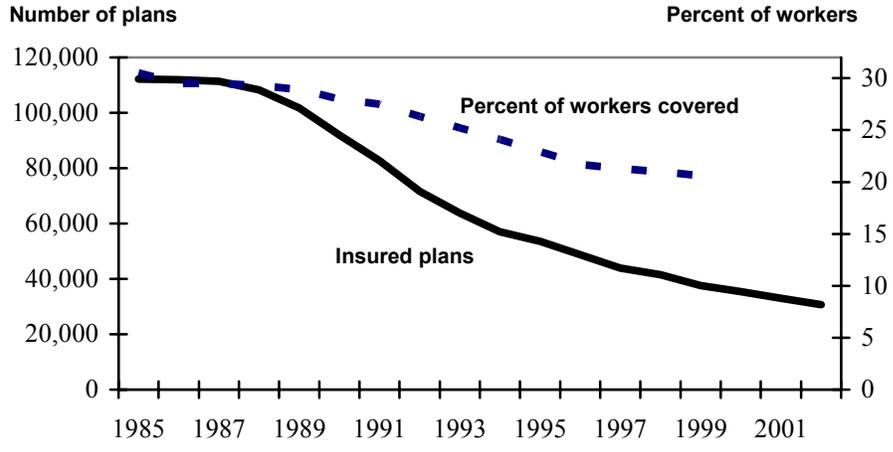
Johnson and Steuerle reckon that by shifting from traditional pension plans to hybrid pension plans employers may be better positioned to meet the challenges of a rapidly aging workforce. Unlike traditional pension plans, hybrid plans do not discourage workers from remaining on the job at older ages — a trend that may be necessary to meet future labor demands. Additionally, by promoting work at older ages, employers will not only be meeting their corporate objectives, but will also be indirectly assisting national retirement policy objectives as workers will not turn to public programs as early as they do now.

The primary characteristics of a traditional defined pension plan may have made sense a few decades ago — when younger employees were in great supply — but do not match the trends of today's labor market. Workers in traditional defined benefit plans can lose pension wealth if they stay on the job beyond a certain age or seniority level. For every year that workers remain on the job past the plan's retirement age, they give up a year of retirement benefits. Additionally, many plans include early retirement subsidies.

Unlike traditional plans that accumulate the greatest pension wealth in the middle years of employment with the same company, hybrid plans reward work at all ages and allow greater portability. The authors acknowledge that changes to hybrid plans can be controversial if not handled properly and that other solutions for traditional plans could emerge in the future, such as eliminating early retirement subsidies and indexing benefits from the time that the worker leaves

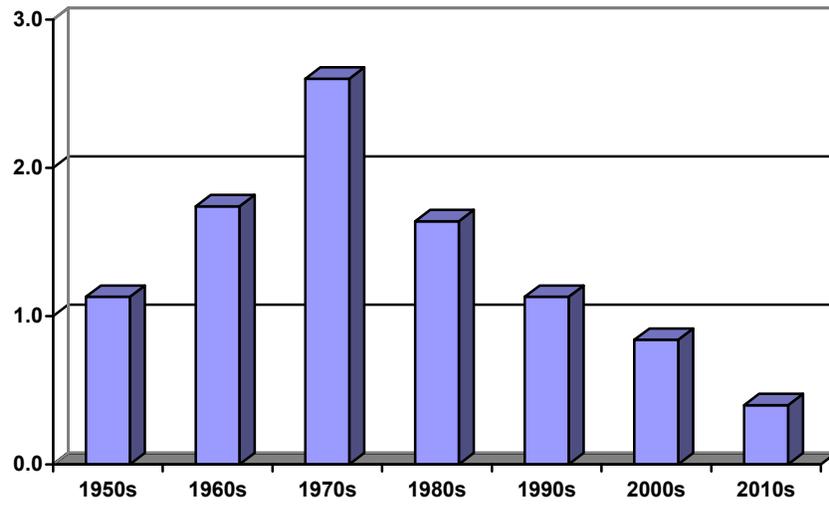
the job. They conclude that the movement toward hybrid pension plans can be used to increase work incentives for older adults, a potentially desirable outcome in the face of an aging population.

**Figure 1. Number of private defined benefit plans insured by PBGC and Percentage of Private Sector Workers Participating in these Plans**



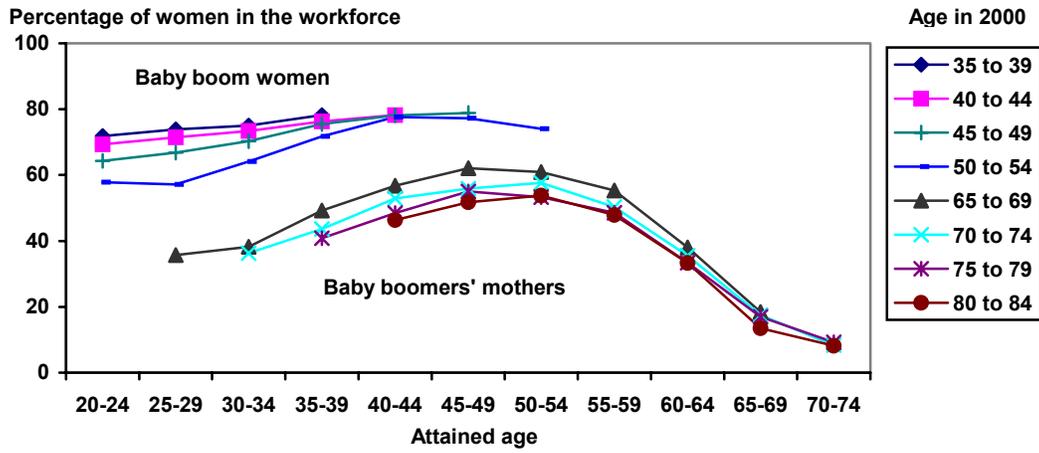
Source: PBGC, *Pension Insurance Data Book* (1996 and 2002).

**Figure 2. US Civilian Labor Force Growth Rates for Selected Decades**

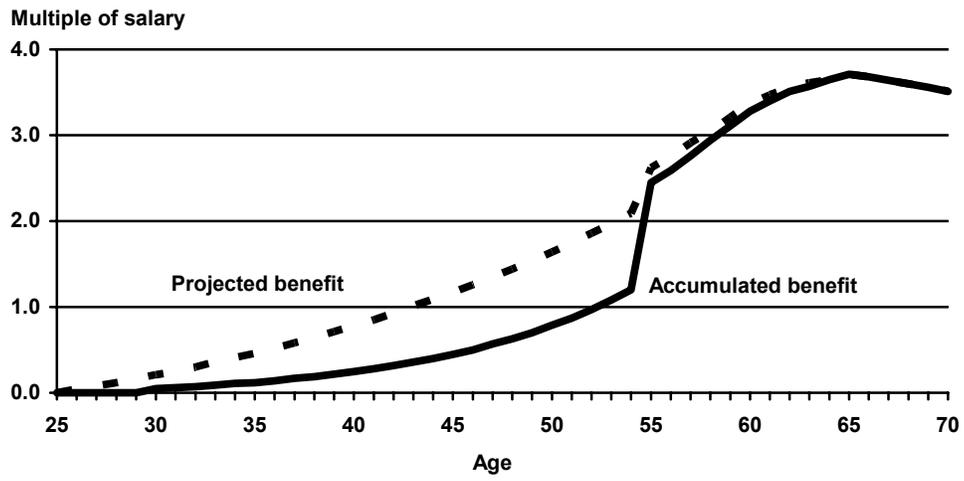


Source: Council of Economic Advisors, (2000).

**Figure 3: Labor Force Participation Rates of Mothers of the Baby Boom Generation by Age in 2000 at Various Attained Ages throughout their Lives**



Source: US Department of Labor (2000).

**Figure 4. Accumulated Benefits and Projected Benefits as a Multiple of Current Salary**

Source: Compiled by Author.

**Table 1. Distribution of Wealth among the Near Elderly**

Position in the Wealth Holding Distribution	Retirement Purchasing Power from:			
	Personal Financial Wealth (percent)	Social Security Wealth (percent)	Pension Wealth (percent)	Total Wealth (percent)
Bottom 10th	3.4	93.6	3.0	100.0
1/3 from bottom	18.1	63.4	18.5	100.0
2/3 from bottom	29.9	35.7	34.4	100.0
Top 10th	65.2	10.2	24.6	100.0

Source: Moore and Mitchell, (2000).

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