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PWBA Needs to Improve Oversight of Cash Balance Plan Lump Sum Distributions

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EXECUTIVE SUMMARY

Industry estimates state that since the mid-1980s between 300 and 700 traditional defined benefit pension plans have converted to cash balance plans. We could find no authoritative numbers. However, one estimate indicates these conversions affect over 8 million working Americans and involve pension assets of over $334 billion. OIG conducted an audit to determine if the Pension and Welfare Benefits Administration's (PWBA) oversight of these cash balance plans was adequately protecting participants' benefits. In making this determination, we audited a judgmental sample of 60 converted plans to see if plan administrators had complied with the Employee Retirement Income Security Act of 1974, as amended (ERISA).

PWBA has devoted considerable resources on cash balance plans focusing on disclosure and education. PWBA also recently initiated a project regarding conversion fees, a potential prohibited transaction. PWBA, however, has not devoted significant enforcement resources to protecting participants' benefits in cash balance plans.

We audited the conversion and distribution processes in 60 converted cash balance plans to determine if PWBA needed to increase enforcement efforts. Our analysis of the 60 converted cash balance plans found that the conversions adequately protected benefits from earlier plans. However, in 13 of those 60 plans, we found that workers who left employment before normal retirement age did not receive all the accrued benefits to which they were legally entitled; being underpaid an estimated $17 million each year. Applying the same estimation model used in our judgmental sample to the estimated 300 to 700 defined benefit plans that have converted to cash balance plans, we estimate that workers may be underpaid between $85 million and $199 million annually.

We believe that additional PWBA oversight and intervention could help prevent future underpayments to workers in cash balance plans and correct past underpayments, where possible, within ERISA time constraints. We, therefore, recommend the Assistant Secretary for Pension and Welfare Benefits strengthen PWBA's oversight of cash balance pension plans by:

1. Directing more enforcement resources to protecting cash balance plans' participant benefits.

2. Initiating specific enforcement action on the 13 plans with forfeitures identified in this audit.

3. Working with IRS to develop improved guidance for plan administrators in calculating participant accrued benefits.

In its March 26, 2002, response to the draft audit report, PWBA identified potential legal restrictions to its ability to enforce ERISA §§203 and 205. PWBA stated that, because of these restrictions, it needed the Department of the Treasury's official view on the potential violations noted in our draft audit report to properly evaluate our recommendations. PWBA had forwarded

our audit results to the Department of the Treasury but had not received a response as of March 26.

PWBA did provide interim comments pending the official response from the Department of the Treasury. PWBA disagreed with the first recommendation. PWBA disagreed with our methodology in determining sample size and extrapolating the error amount. PWBA questioned our conclusions and stated that without a broader survey of the problem and more detailed information it could not commit to redirecting enforcement resources to cash balance plan benefit calculations.

We continue to believe that PWBA should initiate some sort of enforcement effort with respect to participant benefits in cash balance plans. As to the legal restrictions noted by PWBA, we believe that ERISA §502 (b)(1) may not prevent PWBA from pursuing enforcement as a breach of fiduciary duty under ERISA §404. We believe that PWBA should request a formal opinion from the Solicitor of Labor to determine if PWBA does have such authority.

Also, despite the lack of a statistical approach, we found 13 plans with underpayments to participants out of 60 plans reviewed. Under any sampling or targeting method, statistical or judgmental, this is a disturbing finding. Even disagreeing with our estimate of overall impact, the fact that problems existed in 13 plans out of 60 reviewed should move PWBA into enforcement action. We believe this should be a cause of concern for PWBA and continue to recommend additional enforcement resources be devoted to participant benefits in cash balance plans.

PWBA indicated general agreement with the second and third recommendations. PWBA agreed to take appropriate enforcement action on the 13 plans. The specific action is dependent on the response from the Department of the Treasury. PWBA also agreed to work with the IRS in determining what guidance should be developed on calculating lump sum distributions of accrued benefits in cash balance plans. We have no further comment until we evaluate PWBA's actions after PWBA receives Treasury's response.

INTRODUCTION

Background

Private pension plans are governed primarily by two laws: The Employee Retirement Income Security Act of 1974 as amended (ERISA), and the Internal Revenue Code (IRC).

Three Federal agencies, the Pension and Welfare Benefits Administration (PWBA), the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC), are primarily responsible for enforcing laws related to private pensions. PWBA enforces ERISA's reporting and disclosure provisions and fiduciary standards that cover how plans should operate in the best interest of participants. The IRS enforces participation, vesting, and funding standards for pension plans. PBGC insures the benefits of participants in most private defined benefit pension plans.

ERISA establishes pension plans as either defined benefit or defined contribution plans. Separate requirements govern each type of plan.

Most **defined benefit plans** use a final average pay formula that is based on years of service, average earnings over a specific number of years, and a multiplier. For example, a final average pay formula might determine benefits on the basis of 1.25 percent multiplied by years of service completed, multiplied by the employee's average salary over the past 5 years of service. Defined benefit plans typically express an accrued pension benefit as an annuity beginning at the plan-specified normal retirement age. The employer, as the plan sponsor, is responsible for funding the promised benefit, investing and managing the plan assets, and bearing the investment risk.

Under **defined contribution plans**, such as 401(k) plans, workers have individual accounts to which employers, employees, or both make periodic contributions. Defined contribution plans base benefits on the contributions to, and investment returns on, these accounts. Employees invest their accounts, at least in part, as they choose and bear the risk of poor investment performance.

Cash balance plans are hybrid plans because legally they are defined benefit plans but include features that resemble defined contribution plans. As defined benefit plans, cash balance plans must offer retirement benefits in the form of a series of payments for life – an annuity determined by several actuarial factors. However, like a defined contribution plan, cash balance plans express benefits as an "account balance."

In a cash balance pension plan, each participant has a hypothetical account. The plan credits funds to that "account" over time, consisting of two variables: (1) the employer's hypothetical

"contributions," generally based on pay and (2) hypothetical earnings expressed as interest. The plan usually expresses employer "contributions" as a percentage of salary. Interest credits may be at a fixed interest rate, but more often, they are tied to a variable index - for example, U.S. Government securities.

Hypothetical account earnings are not related to investment returns on assets in the plan's pension trust, and hypothetical accounts are not credited with the plan's actual investment gains or losses. Employees neither own these "accounts" nor generally make investment decisions.

An estimated 300 to 700 plans have converted to cash balance plans

Industry estimates on the number of pension plans that sponsors have converted to cash balance plans since the mid-1980s generally range between 300 and 700. One estimate indicates that conversions have affected over 8 million American workers and involve pension plan assets of over $334 billion. The reasons for converting include: ease and reduced cost of plan administration, portability of benefits, and plan attractiveness to younger workers.

Concerns about cash balance plans

Prompted by concern from members of the Congress and by participants in plans that were converted, Federal agencies are now reviewing age discrimination and other issues involving cash balance plans. Within the past few years, more than 800 workers and retirees have filed age discrimination charges with the Equal Employment Opportunity Commission (EEOC) concerning cash balance plans. The EEOC is continuing to investigate these charges.

The IRS is currently reviewing tax qualification issues raised by cash balance plan conversions. In September 1999, the IRS announced that it would begin requiring a technical review by IRS headquarters of cash balance plan conversions. Although numerous companies have submitted cash balance plan conversions, IRS headquarters has not approved any since September 1999. In October 1999, the IRS announced that it was soliciting public comments on the conversion of traditional defined benefit formulas to cash balance formulas.

Determining Cash Balance Plan Accrued Benefits

The fact that cash balance plans are legally defined benefit plans is critical to determining participants' accrued benefits. Under ERISA, the accrued benefit of a defined contribution plan is simply "the balance of the individual's account." However, for a defined benefit plan, including cash balance plans, ERISA requires the benefit to be expressed in the form of an annual benefit beginning at normal retirement age. Generally, this means an annuity beginning at age 65. In most defined benefit plans, the amount of the annuity is small at the beginning of plan participation and grows larger the longer the participant stays with the sponsor. At any point during a career, a participant's future benefit is determinable.

Under ERISA §203,[1] an employee's right to this future benefit must become non-forfeitable. This means that, while an employer may terminate or amend a pension plan, the sponsor may never reduce or eliminate any benefits already earned by a participant, **including interest credits to retirement age.[2]** Therefore, any benefit distribution must recognize future interest credits as part of the accrued benefit.

ERISA minimum lump sum distributions

For participants leaving employment before normal retirement age, the most common form of payment is a lump sum distribution. ERISA §205 requires that such a lump sum distribution must be, at a minimum, the present value of the normal retirement annuity.

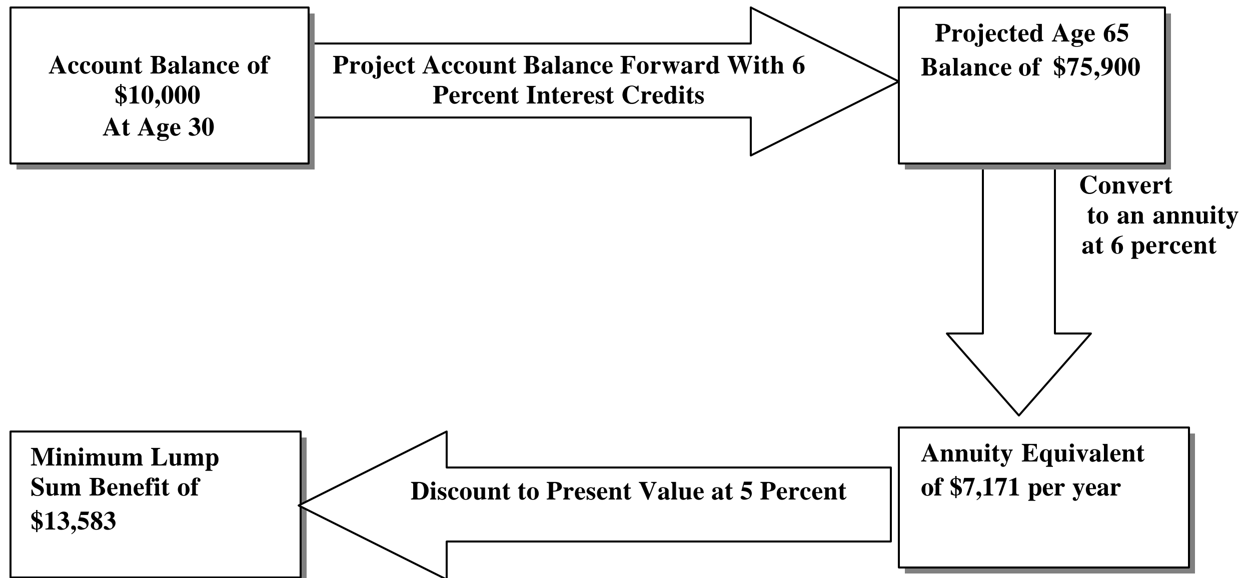
Therefore, to make lump sum distributions in accordance with ERISA §§203 and 205, a plan must project a participant's cash balance account, with interest credits, to normal retirement age. The plan must then convert the projected account balance to the normal retirement benefit, generally an annuity. This normal retirement benefit then must be discounted to present value at the date of distribution, using interest rate and mortality table assumptions. This complex process produces the minimum distribution under the requirements of ERISA.

To protect participants, ERISA §205 specifies valuation factors in discounting retirement benefits. For example, for distributions in 2000 and 2001, ERISA §205 establishes the 30-year Treasury securities interest rate as the maximum discount rate in computing present value.[3] For this same time period, ERISA §205 also required the use of the 1983 Group Annuity Mortality unisex table in present value computations. The present value of the annuity computed using this interest rate and mortality table was the **minimum** that the plan could pay to a participant.

This minimum lump sum payment may be larger than the cash balance account. This occurs if the plan's interest credit rate is larger than the legal discount rate, producing an effect known as "whipsaw." The following figure shows how whipsaw works, assuming an interest credit rate and annuity conversion rate of 6 percent and a discount rate of 5 percent.

[1] ERISA §§203 and 205 are substantially identical to IRC §§411 and 417. Therefore, throughout this report, reference to ERISA §§203 and 205 should be interpreted as also referring to IRC §§411 and 417.
[2] These benefits attributable to interest credits are within the definition of accrued benefits under ERISA §203.
[3] In the past, ERISA had required use of a PBGC rate.

Figure 1: Whipsaw Effect



IRS Notice 96-8

To implement the complex requirements of ERISA §§203 and 205, and the corresponding IRC sections, the IRS issued Notice 96-8, dated January 18, 1996. This Notice applies only to cash balance plans. The Notice explains the present value calculation requirements for the minimum lump sum distribution allowed by ERISA. More specifically, the Notice explains plans must:

- project cash balance accounts to normal retirement age with interest credits,
- determine the normal retirement benefit from this account balance, and then
- determine the minimum benefit by discounting to present value using factors specified in ERISA §205.

The Notice states that this minimum figure may be more than the hypothetical cash balance. If so, the plan must pay the participant the higher amount.

Notice 96-8 recognized that it was the intent of most cash balance plans to use the account balance as the accrued benefit. The Notice pointed out that in order for plans to do this and comply with ERISA §§203 and 205, the plans' interest credit rates, annuity factors, and the ERISA §205 rates would have to be the same. The plan would then project the cash balance account forward, convert it to an annuity, and discount it back using the same rates.

Notice 96-8 recognized that other interest rates could be used and be reasonably close to the ERISA §205 rate. In an effort to create some "safe harbor" rates, Notice 96-8 identified eight other interest indices that may be used and that the IRS would assume to equal the ERISA

required discount rate. The Notice further allowed a margin for each index that would be acceptable as reasonably close to the ERISA §205 rate. The Notice stated that if a plan's interest credit rate was one of the identified indices and was within the margins identified, the plan could assume the projection and discount interest rates were the same. Then, assuming the plan used the appropriate annuity factors, the amount in the cash balance account was considered the same as the accrued benefit.

Although the IRS has not issued the regulations proposed in the Notice as "final," the courts have upheld or applied the concepts of the Notice.[1] Moreover, the courts have applied the Notice's concepts to cash balance plans converted before the IRS issued the Notice. Specifically, in *Lyons v. Georgia Pacific Corporation*, the defendant stated that until the Notice was issued, all it was required to distribute as a lump sum was the amount in the individual employee's hypothetical account. The court disagreed, stating:

> We are skeptical about whether lack of guidance and direction can be defense to this type of action by a plan participant, and in any event Treasury Regulation 1.411(a)-11 when read against the Plan's own terms provides enough guidance that Georgia-Pacific is liable to participants even for distributions made before the issuance of IRS Notice 96-8.

The Treasury Regulation referred to was issued in 1988. Moreover, the court stated that employers had been put on further notice with Treasury Decision 8360 that was issued in 1991. According to the court, both of these issuances were clear enough to create liability even before Notice 96-8.

[1] See *Lyons v. Georgia Pacific Corporation*, and *Esden v. Bank of Boston.*

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our audit objective was to determine if PWBA's oversight of cash balance plan conversions adequately protected participant benefits.

Scope and Methodology

In order to achieve our objective, we identified PWBA's level of oversight and reviewed a judgmental sample of 60 converted plans to determine if there was a need to improve oversight.

We met with the Assistant Secretary for PWBA and PWBA's enforcement staff to discuss PWBA's enforcement activities and involvement with cash balance plan policy issues. During the audit, we discussed evolving issues with enforcement staff and provided PWBA extensive audit information on plans reviewed and our conclusions.

We identified defined benefit plans that sponsors had converted from traditional defined benefit plans to cash balance plans. We determined how accrued benefits from the earlier plans were calculated and whether plans adequately protected those benefits. We also evaluated how the cash balance plans determined participant benefits and how the plans paid those benefits to participants.

We attempted to determine how many converted cash balance plans existed. We contacted PWBA, the General Accounting Office, the IRS, and several private organizations and were unable to obtain a reliable count. We also determined that this information was not readily available in the ERISA information system. The ERISA information system contains the form 5500 information plans filed under the IRC. However, the available data did not identify cash balance plans specifically. In an attempt to develop a statistically valid sample of converted cash balance plans, we identified 14,942 large defined benefit plans (more than 100 participants) that had filed form 5500 for 1998. Using a statistically valid approach, we developed a random sample of 191 plans. By contacting each plan from the sample, we identified 23 converted plans. However, after contacting the 23 plans, we found the information about whether the plan was a converted cash balance plan was not reliable and decided the statistical sampling approach could not be used.

We again used the 1998 ERISA information and searched for plans having a title that included "cash balance." This search resulted in the identification of 136 plans, exclusive of the 23 plans previously identified. By eliminating plans with recent PWBA investigations and contacting plans to determine if they, in fact, were converted cash balance plans, a judgmental sample of 60 plans was selected. (See Appendix 1 for plan size and conversion date.) We either visited or obtained records from each of these 60 cash balance plans. We analyzed the records and

discussed our analysis and conclusions, as needed, with plan administrators and administrator representatives, including attorneys and actuaries. We also discussed our conclusions with PWBA and IRS during the audit.

To evaluate compliance with ERISA and IRS regulations, we held numerous discussions with IRS actuarial and legal representatives from the IRS Office of Employee Plans and Tax Exempt Organizations. We also held discussions during the audit with PWBA representatives. In addition, we contracted with an enrolled actuary to provide actuarial expertise as necessary.

We conducted our audit fieldwork from September 2000 through January 2002, and held an exit conference on January 10, 2002. During the week of January 10, 2002, we allowed PWBA to copy all our documents relating to the plans that we had concluded had underpaid their participants so that PWBA could review our findings and calculations in detail.

We performed our work according to *Government Auditing Standards* issued by the Comptroller General of the United States. Our audit included tests of policies and procedures, plan documents, plan records and other auditing procedures we considered necessary in the circumstances.

FINDINGS AND RECOMMENDATIONS

We concluded that PWBA needs to take a more active role in protecting cash balance plan participant benefits. We reviewed PWBA's efforts relative to cash balance plans. We found that PWBA primarily has focused on participant disclosure and education. PWBA has also reviewed conversion fees. PWBA, however, has not directed significant enforcement resources at protecting participant benefits either by (1) reviewing the way plans calculate accrued benefits for those employees who leave before normal retirement age or (2) working with the IRS to improve the clarity and thoroughness of the current guidance on computing participant benefits, i.e., IRS Notice 96-8.

Our analysis of a judgmental sample of 60 traditional defined benefit plans found that a significant number of cash balance plan administrators improperly computed lump sum distributions requirements and the ERISA oversight processes were not detecting and correcting the lack of compliance. More specifically, we found:

- the 60 conversions adequately protected benefits from earlier plans, and
- 13 of the 60 plans were underpaying workers who left employment before normal retirement age.

These underpayments constitute forfeiture of accrued benefits in violation of ERISA §203. For the plans reviewed, we estimate that cash balance plans may be underpaying participants about $17 million per year. Using the same estimation model that we used in our judgmental sample and applying it to the industry estimates of 300 to 700 plans converted since the mid-1980s, we estimate a potential underpayment of lump sum benefits from $85 million to $199 million annually.[1]

Additional PWBA oversight would help correct past and prevent future underpayments. Also, PWBA needs to work with the IRS to provide better guidance for plan administrators to protect participants' accrued benefits.

Conversions Adequately Protected Accrued Benefits

For the 60 plans in our sample, we concluded that the conversions from traditional defined benefit plans to cash balance plans adequately protected benefits from earlier plans. Plan sponsors either (1) converted accrued benefits from earlier plans into cash balance accounts using various present value factors or (2) kept the accrued benefits separate. In either situation, all sponsors ensured that benefits paid after plan conversion exceeded accrued benefits from earlier plans as required by ERISA.

[1] This is a non-statistical estimate. See Appendix 2 for the methodology used to estimate potential underpayments.

Cash Balance Plans are Underpaying Benefits after Conversion

We found 13 of the 60 cash balance plans, or 22 percent, were underpaying participants their accrued benefits when workers left the cash balance plans before normal retirement age. Participant underpayments ranged up to $55,629. The plans underpaid participants because they made errors in (1) projecting and discounting participant benefits, (2) annuity conversion factors, (3) cost-of-living allowances (COLA), and (4) opening balance calculations. [1]

Eight plans did not properly project and discount participant benefits

The most frequent problem found was plans not following the present value projection and discount procedures set forth in Notice 96-8. Notice 96-8 set forth methods that allowed plans to use a hypothetical account balance as the accrued benefit. The Notice also provided instructions to project account balances in other cases. Yet some sponsors chose plan designs which varied significantly from the concepts in Notice 96-8. Those sponsors continued to reason their cash balance plan design allowed them to pay the hypothetical account balance as the accrued benefit. The result was that plans did not compute the present value of the retirement benefit at normal retirement age - even though the present interest credit rate significantly exceeded the discount rate specified under ERISA §205.

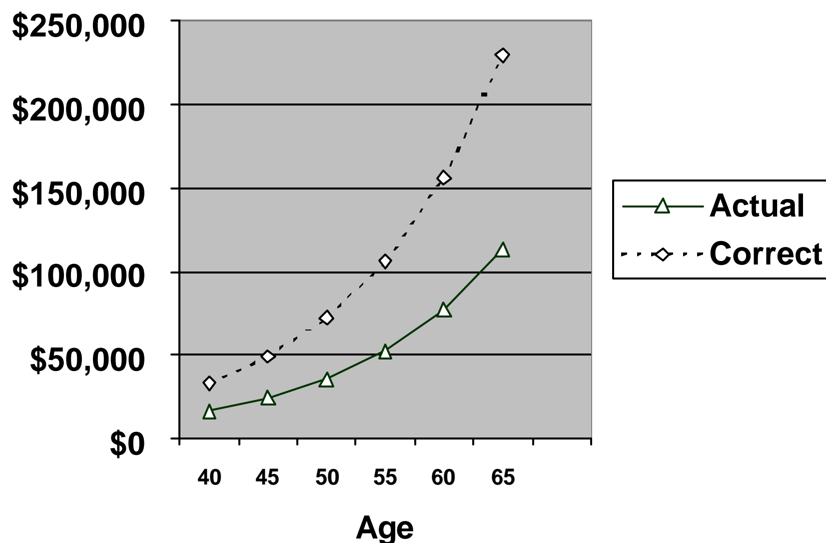
For example, one sponsor established its cash balance plan with an annual interest credit rate of 8 percent. Notice 96-8 does not allow such a fixed rate to be a "safe harbor" rate. In fact, during the 10 years since the plan's conversion, the legal rate set by ERISA §205 for discounting to the present value has ranged from 5.06 percent to 7.97 percent. This means the plan's interest credit rate exceeded the discount rate under ERISA §205 for the last 10 years. Therefore, in all cases, the projection of a cash balance account, at 8 percent to normal retirement age, followed by a discount at between 5.06 percent and 7.97 percent to present value will produce a higher benefit than the account balance. While this is an acceptable plan design under ERISA, according to Notice 96-8, the plan cannot pay the account balance as the accrued benefit and be in compliance. The plan is required to compute the future value of the benefit at eight 8 percent and re-compute the present value at the ERISA legal rate. However, the plan did not compute the present value of the retirement benefit at normal retirement age as required by ERISA. As the following table shows, the plan underpaid two of the participants we tested.

Participant	Account Balance Paid	Present Value	Amount Underpaid
A	$94,853	$98,476	$3,623
B	$15,335	$30,961	$15,626

[1] The errors in opening balance calculations violated plan documents but did not violate accrued benefit requirements of ERISA § 203.

For both participants, the underpayment was significant, especially when the compounding effect on retirement income is considered. Participant B was 39 when he received his cash balance distribution. The figure below shows the effect his underpayment could have assuming he reinvested the distribution into another retirement instrument and received average market returns:

Figure 2: Estimated Cumulative Underpayment[1]



By age 65, the cumulative underpayment to this participant will be over $100,000.

In this case, the plan administrator reasoned that the plan document did not guarantee the higher rate in future years and actually specified that the plan would use a lower rate for projecting accrued benefits. The plan administrator stated that they had followed the plan documents.

In another plan, the sponsor allowed participants to select hypothetical investments and then set each participant's interest credit rate at the rate of return of the hypothetical investments. The interest credit rate for the participants in our sample varied from 9.01 percent to 16.5 percent. This interest credit rate is not one of the "safe harbor" rates of Notice 96-8 and, thus, would require a projection and discount to arrive at a present value of the accrued benefit. The plan would not be able to pay the cash balance account as the lump sum benefit. The plan administrator told us that the plan used the ERISA §205 rate for projection purposes and this made the account balance the actuarial equivalent of the normal retirement benefit. However, Notice 96-8 specifically states this would violate ERISA.

[1] This figure assumes an 8 percent rate of return for long-term investment. According to the National Center for Policy Analysis, this approximates the lowest rate of return for any 65 consecutive years. The average rate of return for the period 1926 through 2000 was about 11 percent.

Notice 96-8 states:

> . . . in determining the amount of an employee's accrued benefit, a forfeiture . . . . will result if the value of future interest credits is projected using a rate that understates the value of those credits or if the plan by its terms reduces the interest rate or rate of return used for projecting future interest credits.

In discussing plans when the interest credit rate is higher than the ERISA §205 rate, Notice 96-8 states:

> If such a plan provided that the rate used for projecting the amount of future interest credit rates were no greater than the interest rate under 417(e)(3), the projection would result in forfeiture.

This is exactly what this plan accomplished. While actually accruing benefits at higher rates, the administrator reduced the projection of future interest credits to no greater than the 417(e) rate and paid the account balance as the benefit. The administrator's reasoning was that the plan stated the balance represented the accrued benefit and this allowed the payment as full benefit. The plan also stated that it had a qualification letter from the IRS, which provided IRS approval of the payment method.

We do not agree with either argument. A plan provision that violates ERISA is invalid, as legal requirements take precedence over plan provisions. Also, the courts have held that an IRS qualification letter does not protect a plan as to participant benefits. In one case, *Esden v. Bank of Boston*, the plan sponsor raised this defense and the court concluded that the qualification letter protects the plan from tax disqualification, but does not protect the plan as to participant benefits that may be improperly paid.

Out of the 60 plans in our judgmental sample, eight misapplied the projection and discount concepts of ERISA §203, as explained in IRS Notice 96-8. In general, we found that sponsors had intended to implement plans where they could pay benefits that were equal to the cash balance account but misconstrued Notice 96-8.

We obtained responses from the eight plans. All eight reasoned that they could pay their cash balance accounts as accrued benefits because of the plan design. The eight pointed to a plan provision that allowed this although **none** of these plans used "safe harbor" rates under Notice 96-8. None of the plans could explain how their plan provision preempted ERISA provisions, nor could they explain how lowering the interest credit rate for projection purposes did not violate Notice 96-8.

Three of these plans questioned applying Notice 96-8 to their distributions because the Notice was not issued until 1996 and contained only proposed rules. As stated before, the courts have held that earlier regulations were clear enough to establish liability for plan participants under cash balance plans and that Notice 96-8 did not create any new concepts.

Three plans did not recognize effects of annuity conversion factors

Three plans underpaid participants because they used annuity conversion factors that prevented them from claiming "safe harbor." In order to be "safe harbor," both the interest credit rate and the annuity conversion rate have to approximate the ERISA § 205 rate.

We found three plans that used "safe harbor" interest credit rates, but had annuity conversion factors that did not meet the Notice 96-8 requirement for "safe harbor." In one plan, the sponsor set the annuity conversion at 7 percent while the ERISA §205 rate was 5.78 percent. The higher interest rate produces a higher present value. For example, one participant had a cash balance account of $30,786 and the plan paid that amount as the accrued benefit since the plan had a "safe harbor" interest credit rate. However, when we calculated the present value recognizing the 7 percent annuity conversion factor, the actual present value was $31,986 or an increase of $1,200.

In another plan, the cash balance accounts were to be converted to annuities using the PBGC interest rate with a mortality table set back 2 years. Because this combination of interest rates and mortality produced larger annuities, the present value exceeded the cash balance account. For example, one participant received $23,460 (the account balance) upon termination. However, after projecting the balance to normal retirement age, converting to a normal annuity, and discounting to present value using the maximum rates, we determined that the participant should have received $26,034. This was a $2,574 increase or an 11 percent difference.

All three plans had "safe harbor" interest credit rates but overlooked the fact that their annuity conversion factors increased the accrued benefit present value.

Two of the three plan administrators disagreed with our conclusions. One stated that we had misinterpreted the plan's normal form of benefit and used the wrong annuity factors. Another stated that they had complied with the plan documents and that Notice 96-8 was not the final authority on the issues.

The third administrator accepted our position on the annuity factors but disagreed that final calculations produced forfeitures due to COLA considerations. In doing the recalculations with our annuity factors, the administrator used COLA percentages different than those specified in the plan documents.

Despite the plans' responses, we still conclude that prohibited forfeitures occurred in each plan. In two of the cases, plan administrators have provided explanations that are not consistent with the plan documents. In the other case involving whether Notice 96-8 is the final authority on these issues, the Treasury regulations and the recent court decisions all support application of Notice 96-8 principles regardless of the time period involved.

COLAs were excluded in two plans

In two plans, we found that plan administrators had excluded guaranteed COLA increases from their present value calculations. The plans based their present value calculation on non-increasing annuities, although the plans specified that the normal form of benefit was an increasing annuity.

In one case, the plan documents specified that the normal form of retirement benefit was an increasing life annuity. The plan documents related the annual annuity increases to the yearly increases in the Consumer Price Index, which has averaged about 4 percent over the last 5 years. This means that a 65 year old retiree could expect the annuity to increase over 50 percent during his or her lifetime. This extra value, although included as a normal retirement benefit, was not included in lump sum calculations. Instead, the plan used a non-increasing (constant) annuity for making lump sum payments to participants.

The difference in valuation can be substantial. One participant's present value increased from $16,380 to $18,563, a $2,183 or 13 percent increase. Other participants had similar increases.

The courts have held that COLA's are an accrued benefit. In *Laurenzano v. Blue Cross,* the court held that if a defined benefit plan normally provides a life annuity that includes a COLA, a lump sum distribution in lieu of the annuity must include the present value of the projected COLA payments.

The plans did not agree with our conclusions. One plan stated that we had overstated the value of the COLA and provided complex actuarial calculations adjusting the COLA with factors not mentioned in the plan documents. The other plan also disagreed, stating that the plan was designed to allow payment of the account balance as the accrued benefit.

Opening cash balance account amounts were miscalculated in one plan

One of the plans that excluded the guaranteed COLA also miscalculated the opening cash balance account amounts.

Generally, no regulation governs the initial cash balances in a conversion process. ERISA §203 does require that benefits accrued in the earlier plan be protected. However, the sponsors can do this outside the cash balance plan. In this case, all participants would start the cash balance plan with a zero balance.

In most plans we reviewed, however, sponsors attempted to start participants' cash balance accounts with the actuarial equivalent of their accrued benefits from the earlier plan. Once this design is included in the cash balance plan, plan administrators must follow the plan documents.

We found one plan that did not establish opening balances as required by the cash balance plan documents. In this case, the cash balance plan documents stated that opening balances would be calculated using the earlier plan's actuarial factors. These factors were the PBGC interest rates and a 1976 Project Experience Table for mortality. Instead, the plan used the PBGC rates and the 1951 General Annuity Tables for mortality. This caused significant differences. The plan understated opening balances for the participants in our sample by over $5,000 each.

The sponsor informed us that the actuarial factors included in the cash balance plan were included by mistake. The sponsor stated that the factors actually used were the ones that were supposed to have been in the cash balance plan documents. It is our position that the plan documents control the participant's benefits and the plan should use those to compute the opening balances.

Need for Additional Oversight

We determined that greater intervention by PWBA and improved guidance would provide additional protection to participant benefits. We found that PWBA has focused on participant disclosure issues and has spent considerable resources meeting with employee groups and reviewing specific plan disclosure issues. PWBA has also developed information for participants and posted it on its website. Recently, PWBA initiated a project to examine whether plan funds paid conversion fees, a potential prohibited transaction. PWBA, however, has not directed significant enforcement resources to protecting participant benefits.

Another facet of enforcement oversight is the clarity and thoroughness of the current guidance on computing participant benefits. Notice 96-8 describes the application of IRC §§411 and 417(e) (ERISA §§203 and 205) to lump sum distributions under cash balance plans. While this guidance clearly explains that plans must project accrued benefits to normal retirement age and discount to present value, it does not clearly specify how this is to be done.

Specifically, the Notice recognizes that cash balance plans use numerous variable indices as interest credit rates, and establishes certain indices as "safe harbor." Plans using other rates cannot assume account balances are equal to accrued benefits. According to the Notice, these plans must project interest credit rates to normal retirement age and discount them using the ERISA §205 rate to determine if the present value of a participant's benefit is greater than the account balance.

If a plan is using a variable interest rate, however, the Notice does not specify how to determine the interest rate to use in projection. According to IRS officials, the plan must use a "reasonable" method to determine the interest credit rate to project. One reasonable method suggested was to use the most recent interest credit rate. The courts have also used this method. However, Notice 96-8 does not include guidance on this.

Although IRS has the exclusive authority to issue regulations regarding participant benefits, and PWBA is bound to follow the IRS regulations, PWBA has concurrent enforcement authority over participant benefits and can work with the IRS on regulatory issues.

Conclusion: Cash Balance Plans are Underpaying Benefits After Conversion

Participants in converted cash balance plans may be underpaid millions of dollars in pension benefits each year. Cash balance plans are improperly computing lump sum distributions in a significant number of cash balance plans. As a result, we estimate that cash balance plan participants who leave employment before normal retirement age may be underpaid as much as $199 million annually.

Recommendations

Greater PWBA intervention and improved guidance would provide additional protection to cash balance plan participant benefits. We recommend that the Assistant Secretary for Pension and Welfare Benefits:

1. Direct more enforcement resources toward protecting participant benefits in cash balance plans.

2. Initiate specific enforcement action on the 13 plans with potential forfeitures identified in this audit.

3. Work with the IRS to develop improved guidance for cash balance plan administrators in determining participant accrued benefits.

PWBA Comments

PWBA provided a detailed interim response on each recommendation. (See Appendix 4 for PWBA's complete comments.) Regarding Recommendation 1, PWBA disagreed on the need for more enforcement efforts and stated:

> As part of our review of the recommendation to direct additional enforcement resources to protect cash balance plan participants' benefit accruals, we examined the methodology used in this study. A number of questions came to mind as to whether the sampling methodology employed by the audit team was appropriate for reaching such a broad conclusion and whether the assumptions used to extrapolate the error from the sample to the overall population were correct.
>
> Because of these potential issues with the methodology employed in determining your sample size and extrapolating the error, we question the conclusion that "workers may be losing between $85 million and $199 million annually." Consequently, unless you were able to undertake a broader survey of the problem

> to provide us with more detailed information, we cannot commit to redirecting our enforcement resources to cash balance plan benefit calculations at this time. However, we will continue to coordinate with the IRS on these issues and will take appropriate enforcement action in this area whenever it arises in one of our investigations.

Regarding Recommendation 2, PWBA agreed to take appropriate action but pointed out potential limitations by stating:

> As noted above, PWBA's enforcement oversight with regard to these issues is restricted due to the Reorganization Plan and ERISA section 502(b)(1), and we are awaiting comments from Treasury/IRS regarding the alleged violations identified in your report. Once these comments are received and discussed with the IRS, an appropriate course of enforcement action will be determined in connection with the 13 plans identified in your report. In that regard, there may be issues involving statute of limitations that may limit what enforcement actions can be taken. We, of course, will provide you with a copy of what we receive from Treasury/IRS.

On Recommendation 3, PWBA agreed to work with the IRS on developing guidance for plan administrators on calculating lump sum distributions of accrued benefits in cash balance plans. PWBA stated:

> It is the policy of PWBA to provide the highest quality of service to its customers--over 200 million pension, health and other employee benefit plan participants and beneficiaries and more than 3 million plan sponsors and members of the employee benefit community. PWBA promotes voluntary compliance by plan fiduciaries and works diligently to provide quality assistance to plan participants and beneficiaries. The Secretary has set the protection of pension assets as a top priority and we welcome suggestions on ways in which we can improve our efforts to strengthen the nation's pension system and to protect the pensions of Americans workers. After receiving the Treasury/IRS comments regarding the alleged violations identified in your report, we intend to work with Treasury/IRS on determining what additional guidance should be developed for plan sponsors and others in the regulated community on calculating lump sum distributions of accrued benefits in cash balance plans.

OIG Response

While PWBA pointed out that the Reorganization Plan No. 4 of 1978 transferred regulatory issuance authority to the IRS and ERISA §502 may place some potential restrictions on PWBA's ability to enforce ERISA §§203 and 205, the main reason for not implementing the first

recommendation was that PWBA had questions regarding the extent of the problem. We disagree for several reasons.

First, using one of PWBA's measurement of enforcement success, the problems we pointed out deserve PWBA attention. Over the last five years, PWBA's own highly targeted enforcement efforts have disclosed violations in an average of about 28 percent of civil cases closed. We did not target our audit efforts yet disclosed potential violations in 13 of 60 cases or slightly more than 20 percent. This compares very favorably despite any disagreements on dollar impact.

Also, during our review we developed review techniques which, if used by PWBA, would substantially reduce staff time spent on non-productive cases. We would be willing to share these techniques with PWBA.

Further, while questioning the extent of the problems in participant accrued benefits disclosed by our review of 60 plans, PWBA has initiated a review of cash balance plan conversion fees. In terms of potential dollar impact, participant benefits are much larger than conversion fees and have a much greater potential impact on individual participants. While our estimate is not statistically developed, we believe it is a reasonable proxy of the problem size.

Since PWBA is reviewing cash balance plans for conversion fee payments, PWBA could expand the scope of that review and include participant benefits while they were reviewing the plan. We do not understand how, given our audit results, PWBA can justify not looking at participant benefits while they are reviewing a cash balance plan for other violations.

Therefore, we continue to believe that PWBA should initiate some enforcement effort toward participant benefits in cash balance plans.

While PWBA did not disagree on the second and third recommendations, implementation is dependent on the IRS response to PWBA's request. We have no further comment until we evaluate PWBA's actions after they receive the IRS response.

We continue to believe that PWBA should initiate some sort of enforcement effort with respect to participant benefits in cash balance plans. As to the legal restrictions noted by PWBA, we believe that ERISA §502 (b)(1) may not prevent PWBA from pursuing enforcement as a breach of fiduciary duty under ERISA §404. We believe that PWBA should request a formal opinion from the Solicitor of Labor to determine if PWBA does have such authority.

Conversion Dates, Participants, and Assets For Plans In Audit Sample

Plan Number	Conversion 1/ Date	Active 2/ Participants	Assets 2/ (in thousands)
1	1/1/98	184	$587
2	1/1/95	5,407	441,584
3	1/1/94	5,969	63,782
4	1/1/92	15,768	813,778
5	10/1/86	5,717	671,531
6	7/22/89	413	7,028
7	1/01/96	401	7,551
8	1/1/87	1,974	42,416
9	1/1/87	1,536	103,430
10	8/1/88	665	17,877
11	8/1/90	802	31,487
12	1/1/95	568	21,710
13	1/1/90	3,282	64,218
14	1/1/98	240	5,696
15	10/1/89	88	7,212
16	1/1/99	624	7,732
17	1/1/95	1,296	59,847
18	7/1/92	0	7,256
19	1/1/92	1,207	28,449
20	10/1/88	2,044	118,453
21	1/1/89	180	12,308
22	1/1/99	1,481	5,830
23	7/1/96	15,615	6,500,543
24	5/6/96	2,513	43,996
25	1/1/90	369	14,928
26	1/1/84	175	1,565
27	1/1/94	1,081	27,722
28	7/1/97	253	11,512
29	1/1/97	9,621	494,811
30	1/1/94	538	9,656

Source: 1/ Plan Documents
2/ 1998 Form 5500

Conversion Dates, Participants, and Assets For Plans In Audit Sample (continued)

Plan Number	Conversion 1/ Date	Active 2/ Participants	Assets 2/ (in thousands)
31	7/2/91	694	6,642
32	1/1/94	778	32,544
33	12/31/00	568	16,420
34	7/1/96	202	11,059
35	1/1/89	11,395	29,906
36	1/1/98	5,115	131,077
37	1/1/97	904	9,889
38	1/1/97	5,650	246,958
39	12/31/94	48	19,982
40	4/1/96	3,767	242,141
41	7/1/98	1,717	647,884
42	1/1/96	1,119	27,394
43	1/1/91	2,465	116,947
44	1/1/91	970	10,980
45	1/1/94	2,470	286,303
46	1/1/96	1,213	19,499
47	7/1/97	2,671	54,371
48	1/1/90	13,340	676,638
49	8/1/98	1,939	246,149
50	11/1/87	4,775	156,518
51	1/1/99	6,065	69,746
52	3/1/97	2,836	467,144
53	1/1/98	544	70,333
54	1/1/96	9,609	247,933
55	3/1/96	19,225	2,502,795
56	1/1/98	707	102,113
57	1/1/95	13,391	139,245
58	1/1/98	2,357	28,192
59	1/1/99	11,597	1,101,762
60	1/1/98	1,077	52,255
Totals		**209,219**	**$17,415,307**

Methodology for Estimating Potential Underpayments

For each plan where we identified benefit forfeitures, we computed the forfeiture for each participant in the sample. We then totaled the forfeitures found for the plan and divided this total by the number of participants sampled, regardless of whether or not they had a forfeiture. This gave us a weighted average underpayment per participant in the sample. The weighted average underpayments ranged up to $37,578 per participant.

Since this average was not dependent on whether or not the participant had a forfeiture, we applied this average to the total active participants in the plan as shown on the 1998 form 5500 This produced a total estimated potential underpayment for active participants in the plan. The estimated underpayments in the sampled plans ranged up to $214,835,332.

To determine a point estimate for each plan, we totaled the potential underpayments and divided this total by the number of plans in our sample (60). Estimated underpayments totaled $373,680,103 which, when divided by 60 plans reviewed, produced a plan point estimate underpayment of $6,228,002 for each plan in the sample. Developing this plan point estimate provided us with a per plan estimate that we used in developing an estimate for the universe.

To determine how much of this underpayment could occur each year, we used a turnover rate developed by the Department of Education, Bureau of Labor and Employment Statistics and published in their Employment, Hours, and Earnings Survey. This survey showed non-agricultural establishments employing 100 and over had an average turnover rate of 4.622 percent.

Recognizing that this turnover rate included retirees who did not leave employment before normal retirement age, we obtained data from the Employee Benefit Research Institute that showed 99.4 percent of participants receiving lump sum payments were under age 65. This was consistent with our sample participants with forfeitures, which only included participants under age 65.

The application of this turnover rate (4.622 percent) to the total estimated underpayment in our plans with forfeitures of $373,680,103 produced an estimated underpayment per year in the sampled plans of $17,271,494. Reducing this to account for only lump sum recipients under age 65, we multiplied the $17,271,494 by 99.4 percent and concluded participants in these plans could be underpaid an estimated $17,167,865 per year.

Methodology for Estimating Potential Underpayments (Continued)

The application of this turnover rate (4.622 percent) to the point estimate underpayment for all plans of $6,228,002 produced an estimated annual underpayment per plan of $286,488. Reducing this to account for only under age 65 participants (99.4 percent) reduced this figure to $284,769. During the audit, we obtained a range of estimated converted cash balance plans of between 300 and 2,900 plans. However, most industry estimates were from 300 to 700 converted plans. Therefore, we applied the estimated potential annual underpayment of $284,769 to this range, which produced a range of estimated potential underpayments of $85,430,745 to $199,338,406.[1]

[1] The above estimated numbers were obtained doing calculations with a Corel® QuattroPro™ spreadsheet application. Slightly different results may be obtained using other methods due to rounding.

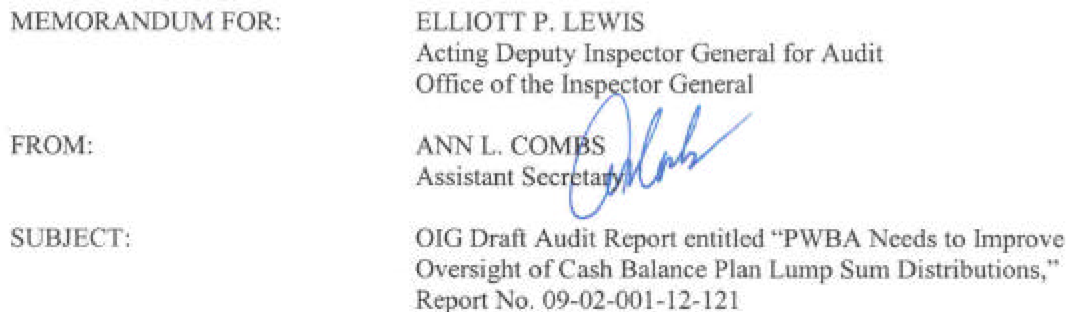
Acronyms

COLA	Cost of Living Adjustment
CPI	Consumer Price Index
EEOC	Equal Employment Opportunity Commission
ERISA	Employee Retirement Income Security Act
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OIG	Office of Inspector General
PBGC	Pension Benefit Guaranty Corporation
PWBA	Pension and Welfare Benefits Administration

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

March 26, 2002



MEMORANDUM FOR: ELLIOTT P. LEWIS
Acting Deputy Inspector General for Audit
Office of the Inspector General

FROM: ANN L. COMBS
Assistant Secretary

SUBJECT: OIG Draft Audit Report entitled "PWBA Needs to Improve Oversight of Cash Balance Plan Lump Sum Distributions," Report No. 09-02-001-12-121

Thank you for the opportunity to comment on the findings and recommendations in your above-referenced draft audit report. The mission of the Pension and Welfare Benefits Administration (PWBA) includes protecting the integrity of private pension, health, and other employee benefit plans covering more than 200 million people. Your draft report analyzes whether PWBA's oversight of cash balance plan conversions adequately protects participants' benefits.

Your draft report states that you "identified PWBA's level of oversight and reviewed a judgmental sample of 60 converted plans to determine if there was a need to improve oversight." You concluded that the conversions from traditional defined benefit plans to cash balance plans "adequately protected benefits from earlier plans" and that "all sponsors ensured that benefits paid after the conversion exceeded accrued benefits from earlier plans as required by ERISA." Your draft report concludes, however, that 13 of the cash balance plans "were underpaying participants their accrued benefits when workers left the cash balance plans before normal retirement age." You assert that these underpayments violated the benefit forfeiture and lump sum distribution rules in sections 411 and 417 of the Internal Revenue Code (Code), and the parallel provisions in sections 203 and 205 of Title I of ERISA. Your draft audit report includes the following three recommendations:

- PWBA should direct more enforcement resources to protecting cash balance plans' participant benefits.

- PWBA should initiate specific action on the 13 plans identified in your draft audit report as having underpaid accrued benefits to participants.

- PWBA should work with IRS to develop improved guidance for plan sponsors in calculating participant accrued benefits.

Before addressing each of your recommendations, we wish to point out important restrictions on our regulatory and enforcement authority in this area that are not noted in your draft report. Under Reorganization Plan No. 4 of 1978, (codified in the notes to 29 U.S.C. 1001), the authority of the Department of Labor to issue regulations, rulings, opinions, variances and waivers with respect to the benefit accrual, forfeiture, and related provisions in Part 2 of ERISA were transferred to the Secretary of the Treasury. While the Reorganization Plan provides that the Secretary of Labor may continue to enforce compliance with the provisions in Part 2, including sections 203 and 205 of ERISA, the Department is bound by regulations and interpretations issued by the Secretary of the Treasury in bringing such actions.

ERISA section 502 (b)(1) further restricts the Department's ability to initiate enforcement actions with respect to alleged violations of Part 2. Section 502(b)(1) provides:

> In the case of a plan which is qualified under section 401(a), 403(a), or 405(a) of the Internal Revenue Code of 1986 (or with respect to which an application to so qualify has been filed and has not been finally determined) the Secretary may exercise his authority under subsection (a)(5) with respect to a violation of or the enforcement of, parts 2 and 3 of this subtitle (relating to participation, vesting, and funding), only if ---
>
> (A) requested by the Secretary of the Treasury, or
>
> (B) one or more participants, beneficiaries, or fiduciaries, of such plan request in writing (in such manner as the Secretary shall prescribe by regulation) that he exercise such authority on their behalf. In the case of such a request under this paragraph he may exercise such authority only if he determines that such violation affects, or such enforcement is necessary to protect, claims of participants and beneficiaries to benefits under the plan.

In light of these restrictions on PWBA's interpretive authority and enforcement oversight with regard to the issues you raised, we concluded, after discussing the issue with your audit team, that we needed the official view of the Department of Treasury regarding the alleged violations identified in your report in order to properly evaluate your recommendations and provide you with comments. Accordingly, and again after discussing the issue with your audit team, we forwarded a copy of your draft report and supporting work papers to the Treasury/IRS for its review and comments. Treasury/IRS has agreed to provide us with comments in writing on your findings. We have asked for Treasury/IRS to expedite their review and we anticipate receiving their response in the near future.

Nonetheless, we would like to offer the following interim comments and observations regarding your draft report and recommendations.

<u>Recommendation No. 1 -- Directing More Enforcement Resources to Cash Balance Plans Benefit Calculations</u>

As part of our review of the recommendation to direct additional enforcement resources to protect cash balance plan participants' benefit accruals, we examined the methodology used in

this study. A number of questions came to mind as to whether the sampling methodology employed by the audit team was appropriate for reaching such a broad conclusion and whether the assumptions used to extrapolate the error from the sample to the overall population were correct.

Because of these potential issues with the methodology employed in determining your sample size and extrapolating the error, we question the conclusion that "workers may be losing between $85 million and $199 million annually." Consequently, unless you were able to undertake a broader survey of the problem to provide us with more detailed information, we cannot commit to redirecting our enforcement resources to cash balance plan benefit calculations at this time. However, we will continue to coordinate with the IRS on these issues and will take appropriate enforcement action in this area whenever it arises in one of our investigations.

Recommendation No. 2 -- Initiating Enforcement Actions On the 13 Plans Identified in the Audit Draft Report

As described in your draft report, IRS Notice 96-8, issued in 1996, addresses certain requirements of Code sections 411 and 417 (and the parallel provisions in sections 203 and 205 of Title I of ERISA) as applied to present value calculations of lump sum distributions from cash balance plans. Your audit team relied on IRS Notice 96-8 in determining whether a plan was in violation of the applicable statutory and regulatory requirements.

As noted above, PWBA's enforcement oversight with regard to these issues is restricted due to the Reorganization Plan and ERISA section 502(b)(1), and we are awaiting comments from Treasury/IRS regarding the alleged violations identified in your report. Once these comments are received and discussed with the IRS, an appropriate course of enforcement action will be determined in connection with the 13 plans identified in your report. In that regard, there may be issues involving statute of limitations that may limit what enforcement actions can be taken. We, of course, will provide you with a copy of what we receive from Treasury/IRS.

Recommendation No. 3 -- Working with IRS to develop improved guidance for plan sponsors in calculating participant benefit accruals

It is the policy of PWBA to provide the highest quality of service to its customers--over 200 million pension, health and other employee benefit plan participants and beneficiaries and more than 3 million plan sponsors and members of the employee benefit community. PWBA promotes voluntary compliance by plan fiduciaries and works diligently to provide quality assistance to plan participants and beneficiaries. The Secretary has set the protection of pension assets as a top priority and we welcome suggestions on ways in which we can improve our efforts to strengthen the nation's pension system and to protect the pensions of Americans workers. After receiving the Treasury/IRS comments regarding the alleged violations identified in your report, we intend to work with Treasury/IRS on determining what additional guidance should be developed for plan sponsors and others in the regulated community on calculating lump sum distributions of accrued benefits in cash balance plans.

If there are questions, my staff would be pleased to discuss these comments with you.