

## A Pension Double Header: Reforming Hybrid and Multi-Employer Pension Plans

Bill Number:

Hearing Date: June 7, 2005, 10:00 am

Location: SD430

Witness:

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Testimony

Chairman DeWine, Senator Mikulski, thank you for the opportunity to appear today. My name is Ellen Collier and I am the Director of Benefits at Eaton Corporation. Eaton Corporation is a diversified industrial manufacturer headquartered in Cleveland, Ohio. We have over 56,000 employees worldwide, including over 29,000 employees in 100 locations in the U.S. The states with our greatest concentration of employees are North Carolina, Michigan, Ohio, South Carolina, Iowa and Pennsylvania. In total, we have employees in over 40 states.

Eaton has four main business groups that manufacture highly-engineered components: Fluid Power, which manufactures hydraulic components, hoses and connectors, and Aerospace products; Electrical, which manufactures residential and commercial power distribution equipment; Automotive, which manufactures engine valves, lifters and superchargers; and Truck, which manufactures transmissions for heavy and medium duty trucks.

Our 2004 sales were nearly \$10 billion, and we sold products in more than 125 countries. The business mix of the company has evolved significantly in the past ten years as a result of more than 100 acquisitions and divestitures. About 65 percent of Eaton's revenues come from businesses that we acquired in the past seven to ten years.

I am appearing today on behalf of the Coalition to Preserve the Defined Benefit System, a broad-based employer coalition that works exclusively on legislative and regulatory issues related to hybrid pension plans. The Coalition's more than 75 member companies, which range from modest-size organizations to some of the largest corporations in the U.S., sponsor hybrid defined benefit plans covering more than 1.5 million participants.

### The Need for Legislative Action

I want to thank you for calling this hearing to address what is one of the most pressing challenges today in the defined benefit system – the legal uncertainty surrounding hybrid plans, and in particular the radical judgment by a single court that hybrid plans are age discriminatory. Congressional action is urgently needed to confirm the dominant view -- expressed by all other legal authorities -- that the cash balance and pension equity designs satisfy current age discrimination rules. Absent such action by Congress to clarify the current legal environment, employers facing the threat of copycat class action lawsuits over the validity of their plan designs will increasingly be forced to abandon these important retirement programs. Given the success of hybrid plans in delivering meaningful, guaranteed retirement benefits to today's workers, abandonment of these

programs would be a disastrous result for employees and for our nation's retirement system. Moreover, with the long-term solvency challenges facing the Social Security program, it is more important than ever to encourage employers to offer robust workplace retirement programs – or certainly not discourage them from doing so. None of us should kid ourselves that somehow employees win if the current uncertainty persists. Nor should any of us assume that a retreat from hybrid plans will be accompanied by a return to traditional defined benefit plans. Indeed, it is far more likely that employers will abandon defined benefit plans altogether.

Congress has before it a number of pressing issues involving our nation's defined benefit pension system, including the need to enact a permanent interest rate to govern the measurement of pension liabilities and required contributions. These are important issues to Eaton and Coalition members generally but we sincerely hope that congressional attention to pension reform funding issues will not distract from the critical task of acting this year to address the hybrid plan issues.

To give you a feel for the valuable role hybrid plans play, let me now discuss why we at Eaton concluded that a cash balance plan was right for us. Our experience is comparable to those of many other companies in our Coalition.

#### The Need for a New Pension Design

Eaton's presence in various lines of business, and our substantial acquisition activity, created a challenge for our retirement programs: we needed to continue to attract and retain high-level talent to remain competitive and continue our growth, and we also needed to reduce the confusion and administrative cost resulting from multiple pension structures inherited through various acquisitions. Through different acquisitions and across different lines of business we had six ongoing pension designs for 15,000 non-union represented employees. These included two final average pay designs, one Social Security offset design, two flat-dollar multiplier designs, and one cash balance design. Based on employee survey results, we also knew we needed to make our pension plans easier for employees to understand.

Eaton began to examine pension plan alternatives in the mid-1990's. We knew the resulting design would need to be attractive to high-skills talent, easy to understand, and suitable to a mobile workforce. This attention to mobility was important – not only because of general trends in the labor marketplace, but also because within Eaton we have employees that transfer between business groups with different pension plans. Under our existing traditional designs, one employee could have benefits from two pension plans, simply by transferring from Pittsburgh (headquarters of our Electrical group) to Minneapolis (headquarters of our Fluid Power group). Finally, any new retirement program would have to permit seamless integration of new employees brought on as a result of acquisitions. This was necessary in order to provide equitable and uniform benefits across our workforce and to enhance Eaton's ability to grow.

While the examination of pension plan alternatives was underway, Eaton acquired Aeroquip Vickers, a company with about 5,000 non-union represented employees. These

employees had a defined contribution plan from the prior owner, but no ongoing defined benefit plan – their pension plan had been frozen many years before. We at Eaton felt strongly that we wanted to provide these employees once again with the security of a defined benefit plan -- in addition to Eaton's 401(k) plan (which has an employer match). We knew that employer funding and assumption of investment risk, professional investment management and federal insurance guarantees translated into tangible retirement income and significant peace of mind for employees. Thus, the need to integrate the Aeroquip Vickers employees into Eaton's benefit structure and our desire to offer them a defined benefit pension made the development of a new pension design even more urgent.

### Key Considerations

We considered several options for a new pension design, including a final average pay plan, a cash balance plan, and a pension equity plan (the other primary variety of hybrid pension plan). We also considered a defined contribution-only program (which we did not prefer, since it lacked the security of a defined benefit plan). In the end, the simplicity, visibility, portability, and ease with which an acquired company could be integrated led us to choose a cash balance design. Along the way, we kept abreast of all regulatory and judicial developments to ensure we were designing a plan that would meet the relevant legal standards. Like most other companies that consider switching to a hybrid plan, Eaton engaged the full range of outside consultants and experts to do appropriate due diligence and assist us with the conversion process.

Now that the basic hybrid designs have been called into question, employers facing a set of circumstances similar to ours would have far fewer options. One choice would be to stay with the traditional pension design, which tends to deliver meaningful benefits to a relatively small number of career-long workers, has limited value as a recruitment device in today's marketplace and makes integration of new employees difficult. The other alternative would be to exit the defined benefit system and provide only a defined contribution plan, which while an important and popular benefit offering, provides none of the security guarantees inherent in defined benefit plans. As these alternatives make clear, it is employees that lose out as a result of today's uncertainty surrounding hybrid plans.

As we at Eaton analyzed our specific situation, we took into account the needs of employees that were already in our other pension designs. We knew that a cash balance design might not meet the needs of every current employee in our existing traditional plans. However, we also knew that forcing current workers to remain in their existing traditional defined benefit plan, while working side-by-side with new workers who earned what might be perceived as a more valuable benefit under the new cash balance design, was also not desirable.

Once we settled on cash balance as our new ongoing design, we then focused on the particular transition approach we would adopt. We were aware of the diversity of transition approaches and knew that each of these transition techniques had proven successful at addressing the needs of particular companies' older workers. Such

approaches include grandfathering employees in the prior traditional plan, offering employees the choice between the prior traditional and new hybrid formulas, providing the “greater of” the benefits under the prior or hybrid plan, providing transition pay credits or making one-time additions to employees’ opening cash balance accounts.

These special transition techniques are used in the vast majority of conversions, and the variety of approaches provides the flexibility companies need to address their unique circumstances and employee demographics. Indeed, congressional concerns about how older and longer-service workers are treated during conversions have been successfully addressed by employers through the use of the variety of transition protections.

We decided that all 15,000 current non-union employees – regardless of age or service – would be able to choose whether to remain in their existing traditional plan or earn a pension benefit under the cash balance formula. This choice would be effective 01/01/03. In addition, all of the recently acquired non-union Aeroquip Vickers employees would enter the new cash balance plan on 01/01/02, and all non-union Eaton employees hired on or after 01/01/02 would enter the new cash balance plan.

We should emphasize that Eaton did not introduce a cash balance plan to reduce cost, and in fact the new plan increased costs in the short-term, and will slightly increase plan costs in the long term. This is described in more detail below.

#### Description of Plan Design

Our new cash balance design – the Eaton Personal Pension Account, or EPPA – consists of several important features. Each participant earns monthly pay credits based on the sum of their age and years of service (including any service with an acquired company). These credits range from 5% of pay up to 8%, increasing as the sum of age and years of service increases. To reiterate, we contribute higher pay credits to the cash balance account of older employees and those with longer service. Indeed, providing pay credits that increase with age or service is the typical approach in hybrid plans. Under Eaton’s plan, the pay credits accumulate, with interest based on the rate of interest for 30-year Treasury bonds, to create the “personal pension account.” Our design benefits employees of a company acquired by Eaton since it recognizes past service with that company when calculating the level of pay credits. The cash balance design is also helpful in recruiting mid-career talent, since age (and not just service) is a component in the calculation of pay credits. Note that we received an IRS determination letter for this basic cash balance design in November of 2002 as it applied to the new Eaton hires and the Aeroquip Vickers employees (none of whom experienced a conversion). We have also received determination letters for our other active cash balance plan and another cash balance plan that has since been frozen due to a spin-off.

An employee who chose to switch to the new Eaton Personal Pension Account would start with an opening account balance equal to the value of their pension benefit under the existing traditional pension plan – including any early retirement subsidies or supplements. Since one of our goals with the new design was to make our pension plan easier for employees to understand, we felt that using an opening balance approach, as

opposed to using the existing traditional formula for past benefits and a cash balance formula for future benefits (the so-called “A+B” approach), was appropriate. To calculate these opening balances, we assumed a retirement date of the later of age 62 or 01/01/06. Employees whose prior pension formula was tied to their final pay (this included the vast majority of the employees eligible for making an informed pension choice) also received indexing credits on the opening balance amount for as long as they remained active employees. These indexing credits were based on annual changes in the Consumer Price Index (CPI) to mimic the effect that pay increases would have had on the employees’ prior pension benefit. These indexing credits were in addition to the ongoing interest and pay credits mentioned above. So, each month a participant’s balance would increase by pay credits, interest credits on the prior balance (including any past pay credits), and indexing credits (on the opening balance only).

A final, but important, note regarding our plan design change is that we made several costly changes to the existing traditional plans as well. Our intention was to remove certain differences in the plan designs in order to make the choice process even more equitable. For instance, we added a non-spousal death benefit and an enhanced disability pension provision to the traditional plans -- both were features of the new cash balance design -- to ensure that an employee’s choice would not be skewed by concerns over unexpected death or disability. We had concluded that the existing “spouse-only” death benefit in our traditional plans was not meeting the needs of single parents working at Eaton.

Along with changes in our pension plan, we also made important changes in our 401(k) savings plan. These changes included permitting diversification of the company stock matching contribution. The decision to permit diversification had been made prior to news reports of troubled company savings plans, such as Enron. Under the changes we have adopted, all company stock matching amounts are fully diversifiable.

#### Informed Choice Process

After deciding on the design, and to give existing employees choice, we had to ensure that the new plan and the choice were communicated clearly to all affected participants. For the recently acquired Aeroquip Vickers employees, who would be receiving a new pension for the first time since joining Eaton, we issued Summary Plan Descriptions, held on-site meetings, and created a website where employees could model future EPPA benefits under a variety of economic assumptions.

For the choice process, we drafted written communication materials with the intent of satisfying -- and, in fact, exceeding -- ERISA section 204(h). Each employee received a detailed Decision Guide, an individualized Personal Choice Statement, and an easy-to-read Quick Comparison Chart. In developing these materials, we kept in mind the high standard that had been set by Kodak -- whom Senator Moynihan publicly cited as the “gold standard” for hybrid conversion communications -- during its choice process, and strived to meet or exceed it. In addition, we made continual use of employee focus group feedback to refine these materials.

The Decision Guide explained, in detail, the features of the participant's existing traditional plan and the EPPA, including details regarding the calculation of the opening balance. This document displayed charts of both options – the current plan and the EPPA – and how they compared at future ages under a certain set of assumptions, using hypothetical examples. In addition, we explained the concept of wear-away, and graphically described the effect it could have on employees. The Quick Comparison Chart was a side-by-side comparison of the main provisions of each option. We should note that Eaton's approach minimized the effect of wear-away. The inclusion of early retirement supplements and subsidies in employees' cash balance opening accounts, as well as the effect of indexing credits, mitigated the effect of, and shortened the duration of, wear-away in most cases. In fact, often it was the inclusion of early retirement supplements in the value of the protected benefit under the existing traditional design – a pro-employee change that is not required by law – that caused an appearance of wear-away.

The Personal Choice Statement used actual individualized participant data so that each employee could compare their estimated future benefit accruals under each option, under a certain set of assumptions. The data used for these statements was audited in advance of, and in anticipation of, this project. In particular, each of the 15,000 eligible employees was asked to review and confirm or correct their work history so that accurate service data was used for any estimate.

After the written materials were sent out, we held over 250 educational meetings and web casts at all 100 U.S. and Puerto Rico locations. Spouses and financial advisors of employees were also invited to attend these meetings, which were led by independent third-party pension experts.

We also developed a website where employees could model individualized scenarios based on their own differing economic assumptions, including salary increases and interest rate assumptions. In addition, the Choice Website contained all the educational information that was included in the written materials.

If employees had questions, they could call the Pension Choice Helpline, where independent third-party pension experts answered questions about the different plans and ran individualized comparisons on the spot. If there was a question that the Pension Choice Helpline representatives could not answer, we made sure the employee was connected to someone at Eaton who could answer his or her question.

If an employee did not make a choice, he or she remained in his or her existing traditional plan. In addition, we permitted employees to make a one-time change in their initial choice during a "grace period."

#### The Reception

At the end of the day, we wanted to make sure that all participants had enough information to make an informed choice. Based on the overwhelmingly positive reaction we received from employees, we believe we accomplished that goal.

Across the board, employee reaction was very positive regarding the pension choice process. The vast majority of employees said that the materials provided helped them make an informed decision. In fact, employee feedback indicates that this process helped employees understand their existing traditional pension plan as well as the new cash balance option. In addition, we received many comments that this process only strengthened the trust that existed between Eaton and its employees. We received no letters of complaint and encountered no disruption in daily business operations during the conversion process.

In the end, about one-third of eligible employees chose the EPPA. The breakdown by age and service went as expected. Of the employees more than 20 years away from retirement, over 60% elected to switch to the EPPA. Of the employees at retirement age or within 10 years of retirement, over 80% elected to remain in their existing traditional pension plan. However, there were several instances where, after modeling personalized scenarios and reviewing examples in the Decision Guide, employees close to or at retirement eligibility chose the EPPA. It was not unusual for the EPPA to provide a greater benefit for a retirement-eligible employee some years in the future, largely due to the inclusion of early retirement supplements and subsidies in the opening balance and the application of indexing credits. Had we kept these employees in their current pension design, we would have deprived them of a chance to increase their pension benefit, even at a point late in their careers. Of the employees between 10 and 20 years from retirement, over 40% switched to the EPPA.

I was in the “in-between” group mentioned above, and although I chose to remain in the existing traditional plan, both benefit designs had distinct advantages depending on my expectations regarding my future career path. Before joining Eaton, I worked at a company where I participated in a cash balance plan for 12 years. As a mid-career hire at Eaton, and as a full-time working mother, it’s important to me to have retirement benefits that fit my needs. The employee reaction to Eaton’s decision to implement a cash balance plan and provide an informed choice was overwhelmingly positive. This, along with similar data from numerous surveys, indicates that employees understand and appreciate the need for companies to have flexible retirement programs that fit the needs of today’s workforce.

All in all, the choice process set a new standard at Eaton for communicating change throughout the company. However, we recognize that choice may not be the right answer for other businesses and other employee populations, and under different circumstances, it might have been the wrong answer for Eaton. Some employers, for example, have focused on grandfathering employees or pursuing a “greater of” approach rather than asking their employees to choose between the plans. Other companies, while scrupulously protecting benefits already earned (as current law requires), have been limited by economic circumstances in the degree of special transition benefits they can provide.

Our Coalition believes it would be extremely unwise to mandate particular transition

techniques for future conversions, as some in Congress have proposed to do, since a broad range of methods is available to ensure that employees are treated fairly in the transition process. One mandated conversion method -- or even several -- would deny employers needed flexibility to customize their transition approaches to their particular workforce. Such conversion mandates -- to pay the greater of the traditional or hybrid benefits or to offer choice, for example -- also provide employees with a guaranteed right to future benefits that have not yet been earned.

These mandates would represent a disturbing shift in the basic norms of American industrial relations. Employee hopes or expectations as to future benefits would be converted into explicit legal entitlements. This profound change from existing principles suggests that the terms and conditions of a worker's employment may not be revised from those in existence at the time the employee is hired. Such a regime would rob employers of the ability to adapt to changed circumstances and would undermine the business flexibility on which America's prosperity and robust employment are built. Presumably, policymakers would not restrict employers from being able to alter -- on a prospective basis -- their 401(k) match level or the design of their health plan -- but this is exactly the kind of restriction that mandated conversion techniques impose. Our Coalition sees no end to the harm if Congress goes down the path of converting expectations into legal rights. Certainly, employers will be extremely reluctant to institute any new benefit programs in the future, and those employers that today do not offer pension or health plan coverage for their employees will be extremely unlikely to do so.

#### The Cost

It is very important to note that Eaton did not introduce a cash balance plan to reduce costs. In fact, the long-term ongoing cost of the EPPA is slightly higher than the steady-state costs of the prior pension plan designs. In addition, we incurred higher short-term costs due to the fact that most participants maximized their benefits, and therefore the cost to Eaton, when they made their individual pension choice. Outside of direct plan costs, Eaton spent several million dollars in the overall choice effort, including consulting fees, communication materials and pension modeling tools, as well as lost work hours due to employee meetings.

Based on press accounts about cash balance conversions, one might expect that Eaton's cost experience is atypical. This is not the case. Recent surveys confirm that conversions to hybrid plans typically increase costs. Recent data from a Watson Wyatt Worldwide study examining 55 large companies that have recently converted from traditional defined benefit plans to hybrid plans shows that retirement plan costs increased by an average of 2.2% following a conversion. This figure further increased to 5.9% when seven companies that were in severe financial distress were excluded from the pool.

#### The Ramifications if Congress Does Not Provide Clarity

If Congress does not move quickly to provide legal certainty for hybrid plans, many Americans may soon lose valuable retirement benefits. The current legal landscape is ominous. One rogue judicial decision has made the threat of age discrimination class action litigation a very real concern for employers with hybrid and many other forms of



defined benefit plans. This is no longer a mere theoretical threat as numerous employers with hybrid plans have now been sued in copy-cat class action suits alleging that the very design of their hybrid plans is age discriminatory. Asserted damage claims in these suits reach astronomical figures -- into the hundreds of millions and even billions of dollars -- and the potential amounts of these awards continue to grow the longer the plans remain in effect. In Eaton's case, the cost to modify our plan for alleged "age discrimination" in its design would curtail our ability to commit funds for other important functions, such as for research and development -- and this is for a plan that has not yet been in existence for 4 years!

Beyond the cost in dollars, there would be increased complexity in the administration of our benefit programs and the programs would be harder to understand should we have to "correct" for the natural effect of compound interest. Moreover, any change to our well-received conversion process would greatly disrupt our day-to-day business operations. If a remedy would require Eaton to redo the choice process, there would be even more confusion, complexity and business disruption. Worst of all, there would be a huge impact on employee morale and employee trust. Eaton prides itself on building trust with its employees, and we believe that the cash balance conversion experience strengthened that trust.

Like the majority of other employers who switch to a cash balance design, Eaton made every effort to act in "good faith" during our conversion. As opposed to adopting a less costly, less secure and less controversial defined contribution design, Eaton incurred additional cost through the conversion process, provided a variety of communications materials and tools, used a fair conversion method, and minimized the effects of wear-away. Without legislative clarification that our cash balance design is age appropriate, the efforts we made to align our benefit structure with our business needs, while at the same time enhancing benefits for and strengthening trust with our employees, will have been wasted.

In today's economic climate, prudent business leaders seek to minimize corporate risks not associated with the company's core business. As you are aware, sponsorship of a defined benefit plan of any variety entails a number of costs and uncertainties for a company, and such costs and uncertainties are likely to increase in the coming months as a result of legislation to reform the pension funding rules and increase the premiums employers pay to the Pension Benefit Guaranty Corporation. The very real litigation risks hybrid plan sponsors face today are over and above these extremely significant costs and uncertainties accompanying defined benefit plan sponsorship generally. Absent congressional action to mitigate the specific risks associated with hybrid plan sponsorship, business leaders will likely be forced to terminate or freeze hybrid pension plans in order to limit exposure to class-action litigation with 9 or 10 figure damage awards. Indeed, in light of these litigation risks, a number of large U.S. employers have already frozen their hybrid pension plans in recent months, deciding to no longer offer any sort of defined benefit pension program to their new hires. It should be noted that the bulk of employers that have moved to hybrid plans have concluded that the traditional pension design no longer meets the needs of large numbers of their current and future

employees. Thus, these employers are extremely unlikely to return to a traditional defined benefit plan after freezing or terminating their hybrid plan. The recent freezes by large employers bear this out. The unfortunate freezes and terminations of recent months will only become more widespread should legislative resolution of the hybrid issues take longer.

Why must Congress be the one to act to clarify the validity of the hybrid designs? First, Congress has indicated through the appropriations process that it does not want these important policy issues being determined by the federal regulatory agencies. As a result, the Treasury Department has withdrawn its proposed regulations addressing hybrid plans and age discrimination principles, which had the potential to settle the open issues regarding hybrid plans. Second, final resolution of the age discrimination question by appellate courts is years away at a minimum, too late to address the litigation risks that are beginning to drive employers from hybrid plans and the defined benefit system. Neither are the courts the appropriate forum to consider the broad public-policy ramifications (for employees and their families, for employers, and for our nation's retirement policy) of holding the cash balance and pension equity designs to be age discriminatory.

In order to prevent widespread abandonment of hybrid plans by employers – and the loss of retirement security this would produce for millions of American families – Congress must clarify that the cash balance and pension equity designs are age appropriate under current law. Congress should also provide legal protection for the hybrid plan conversions that have already taken place in good faith reliance on the legal authorities operative at that time. Finally, should Congress decide to establish rules to govern future conversions, our Coalition strongly recommends that it avoid the mandates guaranteeing future benefits that will merely accelerate employers' departure from the defined benefit system.

Resolving the hybrid pension issues appropriately is particularly urgent given the many challenges American families face in achieving retirement security. With Social Security facing solvency problems that could well result in benefit reductions, with personal savings rates at near-historic lows, with employees bearing significant market risk in 401(k) and other defined contribution plans, with retiree medical costs continuing to soar and with life expectancy continuing to increase, now is precisely the wrong time to encourage employers to depart from the hybrid pension plans that provide guaranteed, employer-funded retirement benefits in a way that suits today's mobile workers. Yet this is precisely what will occur if Congress does not act.

#### Conclusion

Mr. Chairman, I want to thank you once again for calling this hearing. Legislation is the only effective way to address today's uncertainty surrounding hybrid pension designs and prevent further erosion of the retirement benefits of American families. Our Coalition looks forward to working with you and members of the Committee to achieve this objective.

Thank you, again, for the opportunity to appear today. I would be pleased to answer any questions you may have.