

Cash Balance Confusion

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Recently, the press has been full of items about cash balance plans that have done little more than create a great deal of misunderstanding. IBM and Xerox recently lost court cases relating to their cash balance plans. Congress has been negotiating various pieces of legislation that prevent the Treasury from issuing final regulation for cash balance plans. What does it all mean? Let's take a look at some of the "myths" about cash balance plans and clarify the facts.

Myth: The decision in the recent IBM court case means that all cash balance plans are illegal.

Fact: The IBM decision only affects the 7th Circuit (a portion of the Midwest US) and it will be appealed. One conclusion drawn from the IBM decision was that cash balance plans are age discriminatory. This point could have a significant impact on cash balance plans in general if other Circuit Courts agree with the conclusions of the 7th.

Myth: Congress agreed to stop the Treasury Department from spending money to issue final cash balance regulations or to fight the IBM court decision.

Fact: This is partially true. After intense negotiations, Congress tentatively decided to lift the funding ban provided legislation is brought within 180 days and the Treasury Department can't use funds to finalize their regulations.

Myth: The Xerox settlement weakens cash balance plans

Fact: The Xerox case wasn't focused on determining the legitimacy of cash balance plans; it was focused on benefits to employees. Under current law and regulations, Xerox had incorrectly calculated lump sum distributions for their employees. They settled the case.

Myth: It would be risky to start a cash balance plan today.

Fact: Now is not a good time to *convert* an existing traditional defined benefit plan to a cash balance plan, since conversions are really the focus of congressional scrutiny. Starting a new cash balance plan is, in our view, less risky, although a risk remains. There are plan design techniques that can minimize the risks in small plans.

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The Mutual Fund Scandal of 2003: A Fiduciary's View

by Joe Nagengast, Allied Consulting Group

The mutual fund scandal demands a response from plan fiduciaries. But how to respond? Everyday brings more accusations and lowers the chances of finding an “untainted” fund company. This article discusses what happened, why fiduciaries must respond, and how they should respond.

What Happened?

A number of the nation's largest and most widely distributed mutual fund companies stand accused of improprieties and illegalities. Some companies will come out of this without a blemish. The reputations of others will be severely, and perhaps, permanently damaged. As of this writing, the list includes Alliance Capital Management, Bank of America (Nations Funds), Bank One, Citigroup, Fred Alger Management, Janus Capital Group, PBGH Funds, Putnam Investments, and Strong Financial. Some have already admitted to wrong-doing and/or opted for settlement with the Securities and Exchange Commission or state regulatory agencies. We can expect additional disclosures to be made in the weeks and months to come.

Most of the alleged violations fall into one of two types of violations: (1) after hours trading — always illegal, and (2) market timing — only illegal if disavowed in the fund's prospectus and then knowingly allowed.

Many of the funds involved in the scandal are widely used in 401(k) plans. The management companies are fiduciaries. Some have not been living up to even a modicum of diligence, let alone complying with the high standards of a fiduciary.

Why must plan fiduciaries respond?

As fiduciaries ourselves, we have a duty to monitor the activities of other plan fiduciaries. We have a responsibility to our plan participants. We are expected, indeed, required, to meet a very high standard. It is often referred to as being, among the highest, if not the very highest, standard in the law.

In the selection and monitoring of plan investments, we are required to carry out our selection process with “the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use...”

In fulfilling the duty to prudently select and monitor plan investments, the plan fiduciary is not strictly responsible for the fund's performance, per se, but is responsible for ensuring that the manager carries out the mandate for which it was chosen.

How should plan fiduciaries respond?

The standard for terminating a relationship with a fund or a manager need not be the same standard for the initial selection.

While some of the accusations may have prevented a committee from selecting a fund, the same accusations may not be sufficient justification for terminating the fund.

The members of an investment committee, acting in their fiduciary capacity, should review the news of the various scandals, determine if their own plan has any of the “tainted” funds, and meet to undertake an ad hoc review. Members may be tempted to resolve the issue with very broad strokes, deciding for example, that any fund company accused of impropriety will be terminated; but ERISA standards do not allow for such a black and white approach. A rash decision could hurt the plan. Ideally, the plan's Investment Policy Statement (IPS) would provide direction as to what type of activity warrants placing a fund on the watch-list or removing the fund from the plan.

Lacking specific direction from the IPS, the fiduciaries will need to rely on mutually agreed upon standards. It should not be too difficult to say, for example, that we won't place our participants' account balances in the care of common crooks.

But what about those charges that are not so clear? Plan fiduciaries will need to review each fund and fund company and the charges against it and make prudent decisions. Is there an untainted alternative? Will it hurt the plan to pull the money out? Special circumstances exist for indirect ownership of mutual funds, such as wrap products or annuities. Certainly these issues need to be carefully weighed when making a decision to retain or terminate. There will be situations in which fiduciaries will decide that the investment company transgressed but there is compelling evidence that the moves to clean house were thorough and sticking with the fund is warranted. In other situations they will decide to immediately terminate the fund. As with other fiduciary requirements, it is not the decision, but the process that evidences fiduciary compliance.

Plan fiduciaries will need information to make their decisions. Two excellent sources of information are plansponsor.com and morningstar.com, both of which have a number of articles on the mutual fund scandal. Additionally, major newspapers, such as the Wall Street Journal, New York Times and Los Angeles Times have published many stories about the scandal. You may also contact me at jnagengast@alliedconsulting.com for a summary of the charges and the dispositions to date. It won't be difficult to collect sufficient data on which to make informed decisions. The assistance of knowledgeable and objective investment or legal professionals may be needed.

The first step is to call your investment committee to a meeting. You also need to get a notice out to all employees and participants in the plan. Tell them that you are undertaking a thorough review and then do so. No action is a decision to stay with your existing funds.

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Fiduciary Liability 101:

What are a Fiduciary's Responsibilities?

In the last issue of *Action Items*, we answered the question of who is a retirement plan fiduciary. In this issue, we'll answer the question of what are a fiduciary's responsibilities.

So you're a fiduciary. Now what?

Plan fiduciaries' duties fall into four major categories: Adhering to the Exclusive Purpose rule, adhering to the Prudent Expert rule, adopting and adhering to an Investment Policy, and selecting and monitoring investment options and service providers. These duties are primarily spelled out in ERISA §404(a).

Exclusive Purpose Rule

The primary and overriding duty of a fiduciary is to act, "Solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan." In other words, fiduciaries are responsible for acting solely in the best interest of plan participants, even if it conflicts with their own interests. ENRON fiduciaries, some of whom were corporate officers, are alleged to have breached this duty when they encouraged participants to invest in ENRON stock while knowing the company was a financial tinderbox waiting for a match to light.

Prudent Expert Rule

Under this rule, a fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

Here's the problem: Few fiduciaries would qualify as investment professionals, yet that is the standard by which they are expected to act when handling retirement plan matters. For that reason, fiduciaries often rely upon outside advisors to guide them through the investment due-diligence process.

Investment Policy

Fiduciaries must ensure that the plan has adopted an Investment Policy, which aids in the process of properly selecting, monitoring, removing and replacing a diversified selection of investment alternatives appropriate for the participants. Investment policies are generally created with the assistance of an investment advisor or vendor.

Selecting & Monitoring Investment Options and Service Providers

This duty is process-focused. Fiduciaries must have a process in place to select and monitor investment options and service

providers. As noted under "Investment Policy" above, investment alternatives must not only be prudently selected on the basis of performance, they must also be appropriate for your particular workforce. Theoretically, offering 70 investment options might be appropriate if your workforce is composed of sophisticated investors, or if you are providing individualized investment advice to participants. However, if your workforce is composed of predominately unsophisticated investors, offering too many investment options may actually be a breach of your fiduciary responsibility. Remember, you're not constructing an investment platform appropriate for your executive team; you're building the platform for the entire company.

Service providers also must be evaluated on a regular basis to ensure they are providing appropriate services at reasonable costs to participants.

Need Help Satisfying Your Fiduciary Responsibilities?

The first step to managing fiduciary liability is to understand it. ACI's consultants can assist retirement plan fiduciaries in this process. Contact your plan administrator or one of our consultants for more information on these services.

2004 Retirement Plan Limits Announced

The Internal Revenue Service announced cost-of-living adjustments for tax-qualified retirement plans for the year 2004. Your plan may impose lower limits than those shown below.

Defined Contribution Plan Limits

Individual Contributions

The limitation on contributions made on behalf of an individual to a defined contribution plan increased to \$41,000. Individuals will now be limited to contributions of 100% of compensation or \$41,000, whichever is less.

401(k) & 457 Deferrals

The dollar limitation on employee deferrals into 401(k) and 457 plans increases to \$13,000.

Catch-up Contributions

The 401(k) catch-up contribution limit increases to \$3,000 (for individuals age 50 or older).

Defined Benefit Plan Limits

The limitation on the annual benefit under a defined benefit plan increases to \$165,000.

Highly Compensated Employee Definition

The dollar limitation on compensation used to determine which employees are considered highly compensated will remain at \$90,000 in 2004. Thus, employees who earn \$90,000 or more for

See "2004 Limits" on page 6

Avoid Distribution Trap

by *Tobi Cogswell, Consulting Administrator*
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In the participant-directed 401(k) world we have come to rely on the ability of vendors to process termination distributions quickly and efficiently on a daily basis. While this may allow participants and plan sponsors to cut their ties and go forward with minimal ongoing contact and angst, it may also present some challenges when making distributions to highly compensated participants.

In a traditional 401(k) plan, the amount of compensation deferred by highly compensated participants (HCEs) is dependent upon the average amount of compensation deferred by the non-highly compensated group (NHCEs). It is only *after* the testing has been completed for a particular year that a highly compensated participant can be assured that no refunds of deferrals will be required. If an HCE has already terminated employment and taken a distribution, challenges arise if he/she is owed a deferral refund for the prior year.

Depending upon the year of distribution and the timing of completion of nondiscrimination tests, there may be problems with the required 1099-R form. If, for example, the HCE terminated and took a cash distribution during 2003, he would receive a 1099-R in February, 2004. If it was subsequently determined that a refund was required for the 2003 plan year, revised 1099-R forms would have to be prepared showing the amount of the refund, plus earnings separate from the remainder of the distribution. This is an enormously time-consuming and frustrating experience for all parties involved.

To make matters worse, if the HCE rolled his distribution to an IRA, not only would revised 1099-R forms need to be prepared, but the amount of the refund plus earnings, would need to be refunded from the IRA. The participant would need to amend his personal tax return to claim the amount of the refund (plus earnings) as ordinary income, rather than as a tax-deferred distribution.

What can you do to avoid this?

- 1) Review your HCEs. For 2004, the definition of an HCE is anyone who is a greater than 5% owner (including spouses, children, grandchildren and parents of greater than 5% owners) and anyone who earned more than \$90,000 in 2003. If an HCE terminates during any plan year, hold off on processing their distribution until the nondiscrimination tests have been completed for the plan year and the test results and refund amounts, if any, have been communicated to you.
- 2) Review your plan document. Typically the section entitled "Distribution Upon Termination" will define the time of distribution as "within an *administratively reasonable* time after Termination of Employment occurs, but in no

event later than the earlier to occur of (1) the date the Terminated Participant reaches Normal Retirement Age, or (2) the Required Beginning Date." Unless a particular HCE is at Normal Retirement Age or has attained age 70½, waiting to make a termination distribution to him would be permitted under the terms of the plan as stated above. Any other circumstances should be discussed with your plan administrator.

- 3) Determine what "administratively reasonable" means to you. Does it mean avoiding potential revised 1099-R forms, refunds from IRAs, amending of personal tax returns, and consulting fees associated with each by waiting to make distributions to HCEs until after the year-end testing has been completed? You can decide.

In the event that you have any questions or would like specific information regarding distributions to your HCEs, please don't hesitate to contact your ACI plan administrator or consultant.

Bonding Requirements and Non-Qualifying Plan Assets

by *Glenda McAfee, Consulting Administrator*
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There are generally two types of bonds that are required for qualified retirement plans:

1. Employee Retirement Income Security Act (ERISA) bond commonly known as a fidelity bond; and
2. Small plan filer bond.

The ERISA bond is required for every fiduciary and every person who handles plan funds. The amount of the bond may not be less than 10% of the amount of the funds being handled and need not be greater than \$500,000. Even though (1) There is an exemption from the ERISA bonding requirement for a fiduciary that is a financial institution under the Department of Labor regulations; and (2) All of the plan assets are invested with a bank or insurance company or under the control of a corporate trustee, an ERISA bond is required in most cases because the financial institution exemption does not cover persons outside the financial institution who are fiduciaries or who handle funds. It is important to point out that fiduciary liability insurance is *not* the same as an ERISA bond.

The small plan filer bond is required if less than 95% of the plan's assets are invested in "qualifying plan assets" and the plan sponsor does not want a written opinion from an independent qualified public accountant. The amount of this bond may

See "Bonding & Assets" on page 6

Employees' Financial Stresses at Home Cost Their Employers Money

by Marc Robinson, Esq.

Studies from the Navy and others reveal that US employers are suffering dollar losses and lost productivity because employees are bringing their financial worries from home into the workplace.

In fact, a year-long study conducted for the Navy discovered that financial worries and the lack of understanding about how to better manage finances were causing the Navy to lose between \$172 million and \$258 million in direct costs, lost productivity, and new employee training costs. Money problems also led to attrition of over 2,900 service members a year.

And a Ford Foundation study titled, *Relinking Work and Life*, concluded that “paying attention to employees’ personal lives increases corporate productivity.”

As a result, industry reports show approximately 80% of companies with 5,000 or more employees have, or are instituting, financial education programs that go beyond traditional 401(k) education. Smaller employers are also recognizing the direct correlation between the financial education and the bottom line

The Hard Costs

The costs incurred by employers include lower job productivity, absenteeism, tardiness, loss of customers who seek better service, loss of revenue from sales not made, accidents and increased risk-taking, health care costs for stress-related illnesses, disability and worker’s comp claims, employee theft, time lost from work to deal with personal finance matters, and employee turnover.

According to Tom Garman, previously the head of the Personal Finance Employee Education Institute, an employee who misses four days of work in one month personally has a 20% loss in productivity (4 days missed divided by 20 working days). Plus, there may be related costs for temporary labor, worker’s comp, employee health care, and increased insurance premiums. There is also the opportunity cost of disrupted productivity among workers inconvenienced by the financially-troubled employee. Garman’s surveys have shown that employees’ financial worries cost employers no less than 10% of their salaries.

Some Possible Signals

Employees may take time away from productive labor to confer by phone with creditors, look for more credit, talk with co-workers about stresses, and take unwise gambles to “hit it big.” Employees may call in sick so they can make court appearances, talk with attorneys, meet with creditors, collection agents, or to just stay at home and “disappear” for a while. Tardiness,

lower productivity, and abnormal human error in accidents may also be signs.

Most Employers Are Unaware

Still, most employers are just catching sight of these profitability links. One reason may be the post-Enron climate. It’s easy to see that employees at any company may now be worried about the future of their retirement plan savings. It’s a short leap from there to recognize that these worries can spill over into work. In addition, it’s easy to understand the stresses that are probably in many homes in these hard economic times; and to take the short leap to how hard it is to leave those stresses out of the workplace.

What Can Be Done?

When the Navy instituted a financial education assistance program, costs and attrition both fell by more than 33%. And studies show that financial education may be a stronger—and certainly cheaper—solution than a company match.

In the coming era of rehiring, in a climate of continuing to keep costs low, the challenge for employers will also be to find low-cost/high-value employee benefits that will add to their competitive profile—and will help their current employees reduce financial stress and maintain high productivity.

Marc Robinson is a lawyer, marketing consultant, and developer of tools for financial service providers. He’s noted nationally for his unique, simple, practical explanations on money topics, and has authored some of the most respected personal finance books available, including titles for The Wall Street Journal, Time-Life, and a current best-selling Essential Finance series for publisher DK Books. He can be reached at topdown@speakeasy.net

Cash Balance *continued from page 1*

While there is a lot of confusion about cash balance plans out there, the fact remains that 25% of all participants in defined benefit plans are in cash balance plans and 40% of all assets invested in defined benefit plans are in cash balance plans. As a result of the downturn in the stock market the past few years, many people consider it in the public’s best interest to have plan participants in defined benefit plans instead of defined contribution plans because in defined benefit plans, it is the employer who takes the investment risk. They are wonderful small plan design tools and have become very popular in professional and entrepreneurial companies.

For an ACI brochure, contact Lace Greene at lace.greene@acibenefits.com

Bonding and Assets *continued from page 4*

not be less than the value of the plan assets which are not qualifying plan assets, without regard to the bonding limit described above.

Qualifying plan assets are any of the following types of investments:

1. Qualifying employer securities
2. Participant loans
3. Assets held by a regulated financial institution
4. Registered mutual funds
5. Investments and annuity contracts issued by an insurance company
6. Assets in participant-directed accounts.

Examples of non-qualified plan assets include limited partnerships, trust deeds and real property. Here's how to calculate bonding requirements in a plan with non-qualifying plan assets:

Total Plan Assets (Beginning of the Plan Year)	\$6,000,000
Qualifying Plan Assets (80% of Total Plan Assets)	<u>\$4,800,000</u>
Non-Qualifying Plan Assets (Minimum Bond Amount)	\$1,200,000
ERISA Bond (Lesser of 10% of \$6M or \$500,000)	<u>\$ 500,000</u>
Additional Bond or Bond Amount (Minimum Bond Amount less ERISA Bond, not less than \$0)	\$ 700,000

Note: *If the ERISA bond cannot be increased to \$1,200,000 or an additional bond cannot be purchased for \$700,000, the Plan may need to secure a "crime policy" for substantially higher premiums.*

2004 Limits *continued from page 3*

the plan year beginning in 2004 will be considered highly compensated for the plan year beginning in 2005.

Annual Compensation Limit

The maximum annual compensation that may be recognized by a plan increased to \$205,000.

Key Employees

The dollar limitation for determining whether an employee is "Key" for officers in a top-heavy plan remains unchanged at \$130,000.

Taxable Wage Base

The Social Security wage base will increase from \$87,000 to \$87,900 in 2004.

ACI In the News

Speeches

Each year, ACI prepares a number of presentations related to employee benefits and compensation issues. Many of the presentations are eligible for continuing education credit and have been presented at various professional conferences. For a complete list of ACI's 2004 Presentation Topics, go to our web site at www.acibenefits.com.

Los Angeles Benefits Conference

The 2004 **Los Angeles Benefits Conference** (LABC) will be held on January 29 and 30th at the Hilton Universal City & Towers in Universal City, CA. The conference is sponsored by:

- Pacific Coast Area Employee Plans, Tax Exempt/Government Entities Division, Internal Revenue Service
- American Society of Pension Administrators (ASPA)
- National Institute of Pension Administrators
- Western Pension & Benefits Conference

ACI's President, Pat Byrnes, is a founding co-chair of the Conference. It is an ideal forum to hear the latest information on pension plans, benefits regulations, litigation, enforcement and compliance. Prominent speakers from the IRS and DOL will be available to discuss employee benefit issues with conference attendees.

For more information regarding the conference, log onto the ASPA web site at www.aspa.org/labc.htm.

ACI Client Education Seminars

2004 401(k) Basic Training: An Introduction to 401(k) Plan Operation. This educational presentation covers items such as non-discrimination testing, HCE & NHCE's, employee deferrals and employer contributions, loans and distributions, deferral timing, payroll issues, rollovers, and QDRO's. This seminar is open to anyone who would like a better understanding on the administration of 401(k) Plans. For the 2004 401(k) Basic Training schedule, please go to our website at www.acibenefits.com.



ACI TURNS 20 YEARS OLD

Actuarial Consultants, Inc. was established by Pat Byrnes on December 1, 1983. Pat's commitment to hard work, client service and technical expertise continues to serve as the foundation for the firm today. Built on these principles, ACI has grown to become one of the Country's most highly regarded compensation and benefits consulting organizations.

