



DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

Embargoed until 2:30 pm EDT
September 15, 2003

Contact: Betsy Holahan 202-622-2960

**Testimony of the Honorable Peter R. Fisher
Under Secretary for Domestic Finance
U.S. Department of the Treasury
Before the Subcommittee on Financial Management, the Budget,
and International Security
Committee on Governmental Affairs
United States Senate**

THE ADMINISTRATION'S PROPOSAL FOR ACCURATELY MEASURING PENSION LIABILITIES

Chairman Fitzgerald, Ranking Member Akaka, and Subcommittee members I am pleased to appear before you with Pension Benefit Guaranty Corporation (PBGC) Executive Director Steven Kandarian to discuss defined benefit pension plans. Executive Director Kandarian will discuss the current financial situation of the PBGC while I will discuss the Administration's proposals for strengthening the long-term health of the defined benefit pension system. A strong pension system requires that we not only make pension benefits more secure for America's working men and women but that we also make certain the system that insures these benefits remains financially sound.

To begin, we must be clear on our objective: we all want to improve the retirement security for the nation's workers and retirees by strengthening the financial health of the voluntary defined benefit system that they rely upon. PBGC's current estimate suggests that pension plans in aggregate are underfunded by more than \$350 billion. To achieve our objective, pension funding must improve. That will not happen until the existing pension funding rules are fixed. The Administration has been working with Congress to analyze the existing funding rules and develop additional proposals to improve and strengthen them.

Making Americans' pensions more secure is a big job that will require comprehensive reform of the pension system. The Administration proposal that we released on July 8 is the necessary first step in the reform process but it is only the first step. Before I outline that

proposal in detail, I would like to summarize briefly the case for comprehensive reform and list some of the topics that we believe reform should address.

Reform Issues

Americans have a broadly shared interest in adequate funding of employer-provided defined benefit pensions. Without adequate funding, the retirement income of America's workers will be insecure. This by itself is a powerful reason to pursue improvements in our pension system.

At the same time, we must remember that the defined benefit pension system is a voluntary system. Firms offer defined benefit pensions to their workers as an employee benefit, as a form of compensation. Our pension rules should thus be structured in ways that encourage, rather than discourage, employer participation.

Key aspects of the current system frustrate participating employers while also failing to produce adequate funding. We thus have multiple incentives to improve our pension system, and to thus better ensure both the availability and the viability of worker pensions. We owe it to the nation's workers, retirees, and companies to roll up our sleeves and to create a system that more clearly and effectively funds pension benefits. Major areas that require our prompt attention include:

1. Funding Rules

Our complicated system of funding rules has been constructed, in part, to dampen the volatility of firms' funding contributions. Yet current rules fail to do so. After years of making few or no contributions at all, many firms are facing precipitous increases in their annual funding requirements. This outcome is frustrating to business and it has failed to provide adequate funding for workers and retirees.

Improvements to funding rules should mitigate volatility, foster more consistent contributions, and increase flexibility for firms to fund up their plans in good times. Specific issues in the funding rules that need to be examined include:

- a. Volatility Caused by the Minimum Funding Backstop.* The current minimum funding backstop, known as the deficit reduction contribution, causes minimum contributions of underfunded plans to be excessively volatile from year to year.
- b. Funding Target.* The existing funding target is based on current liability, a measure with no clear or consistent meaning. We will seek to develop a better target.
- c. Contribution Deductibility.* Together, minimum funding rules and limits on maximum deductible contributions require sponsors to manage their funds within a narrow range. Raising the limits on deductible contributions would allow sponsors to build larger surpluses to provide a better cushion for bad times.
- d. Asset Measurement.* Under existing rules, assets can be measured as multi-year averages rather than current values. Pension funding levels can only be set

appropriately if both asset and liability measures are current and accurate. Failure to accurately measure assets and liabilities contributes to funding volatility.

- e. *Credit Balances.* If a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest can be credited against future required contributions. These credit balances - mere accounting entries -- do not fall in value even if the assets that back them lose value. Credit balances allow seriously underfunded plans to avoid making contributions, often for years, and contribute to funding volatility.
- f. *Benefit Amortization.* The amortization period for new benefits can be up to 30 years long. This may be excessive. We will also look at other statutorily defined amortization periods.

2. Actuarial Assumptions

We also intend to examine how the application of actuarial assumptions in the current funding rules may contribute to funding volatility and to inaccurate measurement of pension liabilities. For example, companies do not want to be surprised to find they have inadequately funded their plans because the mortality tables used in the funding rules are outdated or because those rules fail to account for lump sum payments. We will examine:

- a. *Mortality Tables.* In order to ensure that liabilities are measured accurately mortality estimates need to be made from the most up to date and accurate tables available. On September 3, 2003 the Treasury and the Internal Revenue Service released to the press Notice 2003-62, a request for comments on the mortality tables used in determining current liabilities. The notice, which will be published in the *Federal Register* on September 22, invites comments on methods of projecting mortality and on factors, in addition to age and year of birth, that might be appropriately reflected in any new tables that may be adopted.
- b. *Retirement Assumptions.* Retirement assumptions made by plan actuaries need to reflect the actual retirement behavior of those covered by the plan.
- c. *Lump Sums.* Liability computations for minimum funding purposes need to include reasonable estimates of expected future lump sum withdrawals that are determined by methodologies that are broadly consistent with other estimates of plan obligations.

3. Other Issues

Three other issues also deserve review:

- a. *Extent of Benefit Coverage.* It may be advisable to limit or eliminate guarantees of certain benefits that typically are not funded, such as shutdown benefits.
- b. *Multi-employer Plan Problems.* Multi-employer plans operate under a different set of rules than single-employer plans. Despite these regulatory differences, the same principles of accuracy and transparency should apply to multi-employer plans, and we will be reviewing the best ways to accomplish this.

- c. *PBGC Premiums.* PBGC's premium structure should be re-examined to see whether it can better reflect the risk posed by various plans to the pension system as a whole.

Although comprehensive reform needs prompt attention, the necessary first step is to develop a more precise measurement of pension liabilities. Fixing the pension funding rules won't help unless we give our immediate attention to ensuring that we are accurately measuring the pension liabilities on which those rules rely. Our most immediate task then is replacing the 30-year Treasury rate used in measuring pension liabilities for minimum funding purposes

I think that we all agree that any permanent change in pension discounting rules should not contribute to future pension plan underfunding. In making the recommendations that I am about to describe, the Administration is seeking to measure accurately pension liabilities, in order to provide the necessary foundation for reform of the funding rules, which then will help ensure that pension promises made are pension promises kept.

We face two near-term concerns that must be addressed in getting to a permanent replacement of the current discount rate.

First, firms that sponsor defined benefit plans already are budgeting their pension contributions for the next several years. Near-term changes to the current rules that would increase pension contributions above current expectations could disrupt these firms' existing short-term plans.

Second, many underfunded plans are already facing sharp increases in their required pension funding contributions. Thus, while we must ultimately ensure that liabilities are measured accurately and that firms appropriately fund the pension promises they have made, an abrupt change from the current system could do more short-term harm than good by triggering plan freezes or terminations.

There are two other reform tasks that the Administration recommends for immediate attention. First, the transparency of information pertaining to pension plan funding needs to be increased. Under current law most workers and retirees are not provided with timely information about the funding of their pension plans. We propose to remedy this by requiring that each year sponsors disclose to participants the value of their pension plan's assets and the level of liabilities measured on both an ongoing yield curve basis and a termination basis.

The Administration also proposes that certain financial data already collected by the PBGC from companies sponsoring pension plans with more than \$50 million of underfunding should be made public. Publicly available information would include the assets, liabilities and funding ratios of the underfunded plan, but not confidential employer financial information. This data is more timely and accurate than what is publicly available under current law.

Second, the Administration proposes to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. When firms with below investment grade credit ratings increase pension benefit promises, the costs of these added benefits stand a good chance

of being passed on to the pension insurance system, frustrating the benefit expectations of workers and retirees and penalizing employers who have adequately funded their plans. Under the Administration's proposal, if a plan sponsored by a firm with a below investment grade credit rating has a funding ratio below 50 percent of termination liability, benefit improvements would be prohibited, the plan would be frozen (no accruals resulting from additional service, age or salary growth), and lump sum payments would be prohibited unless the employer contributes cash or provides security to fully fund these added benefits. When a plan sponsor files for bankruptcy the PBGC's guarantee limits would also be frozen.

The Importance of the Discount Rate in Pension Funding

To determine minimum required funding contributions, a plan sponsor must compute the present value of the plan participants' accrued future benefit payments, which is known as the plan's current liability. The present value of a benefit payment due during a particular future year is calculated by applying a discount factor to the dollar amount of that payment. This discount factor converts the dollar value of the future payment to today's dollars. Current liability is simply the sum of all these discounted future payments.

Pension liabilities must be accurately measured to ensure that pension plans are adequately funded to protect workers' and retirees' benefits and to ensure that minimum funding rules do not impose unnecessary financial burdens on plan sponsors. Liability estimates that are too low will lead to plan underfunding, potentially undermining benefit security. Pension plan liability estimates that are too high lead to higher than necessary minimum contributions, reducing the likelihood that sponsors will continue to operate defined benefit plans.

Computing pension liabilities is basically a two step process. In the first step, the plan actuary estimates the payments that will be made to retirees each year in the future. The pension plan's actuary makes these estimates based on the plan's terms, and estimates of how long current employees will work before retirement and receive benefits in retirement. Estimating the future stream of payments involves considerable judgment on the part of the actuary.

Step two, converting the value of future payments to today's dollars, is, by comparison, simple and rather mechanical. To convert payments in a future year to present dollars, the estimated payments are simply adjusted by the appropriate discount rate. Although some discounting schemes use the same discount rate to compute the present value of payments for all future years, it is no more difficult to compute the present value using different discount rates for each future year.

Choosing the right rate is the key to accurate pension discounting. The wrong rate leads to inaccurate estimates of liabilities that can be either too high or too low.

Therefore, the primary goal of the Administration's proposal to replace the 30-year Treasury rate can be summed up in one word: accuracy. Without first accurately measuring a plan's pension liabilities, the minimum funding rules cannot ensure that the firm is setting aside sufficient funds to make good on its pension promises to its workers. Accurate liability measures also provide a firm's investors with valuable information about the pension contributions that

will be made from the firm's earnings. Accurate liability measures allow workers and retirees to monitor the health of their pension plans. Finally, accurate liability measures allow the PBGC as pension insurer to better monitor the health of the overall pension system.

Pension Discounting under Current Law

Since 1987, federal law has required that pension liabilities that determine minimum pension contributions be computed using the interest rate on the 30-year Treasury bond. Liabilities computed using this discount rate have become less accurate over time, as financial conditions have changed. In the late 1980s, inflation was at higher levels than today. As the inflation rate has declined, the term structure of interest rates has changed. Congress recognized this and in 2002 passed legislation that temporarily changed the discount rate to provide funding relief to plan sponsors. This temporary fix expires at the end of this year.

Dissatisfaction with the continued use of the 30-year rate, even on an interim basis, has been expressed by many members of Congress and pension sponsors. This dissatisfaction and the recognition that the 30-year rate is no longer an accurate discount rate make it imperative that a replacement be promptly enacted.

The Administration's Proposal for Accurately Measuring Pension Liabilities

The Administration believes that corporate bond rates, not Treasury rates, should be the basis for the pension discount methodology. Three key issues need to be addressed in selecting a permanent replacement for the 30-year Treasury rate: the time structure of a pension plan's future benefit payments; the appropriateness of smoothing the discount rate; and the appropriate relationship between the discount rate and the computation of lump sum payments.

The proposal I will now set forth deals with each of these issues.

1. *Pension discount rates should be based on market determined interest rates for similar obligations.*

The terms of pension contracts are not market determined because pensions are not bought and sold in an open market and pension sponsors do not compete with one another for participants. However, group annuity contracts, which are very similar to employer sponsored pensions, *are* sold in a competitive market by insurance companies. Group annuity contracts obligate the seller to provide a stream of annual cash payments, in exchange for a competitively priced premium, to individuals covered by the policy. We take the view, as Congress has in the past, that pension discount rates should reflect the risk embodied in assets held by insurance companies to make group annuity payments. These assets consist largely of bonds issued by firms with high credit ratings. Furthermore, the insurance companies issuing the group annuity contracts also have high credit ratings.

Therefore, the Administration proposes that the new pension discount rate be based upon an index of interest rates on high-grade corporate bonds.

2. *Pension discount rates should be designed to ensure that liabilities reflect the timing of future benefit payments.*

Each pension plan has a unique schedule of future benefit payments - or cash flow profile - that depends on the characteristics of the work force covered by the plan. These characteristics include the percent of participants that are retired, the age of current workers covered by the plan, the percent receiving lump sums and whether the covered work force has been growing or shrinking over time. Plans with more retirees and older workers, more lump sum payments, and shrinking workforces will make a higher percentage of their pension payments in the near future, while plans with younger workers, fewer retirees, fewer lump sums, and growing workforces will make a higher percentage of payments in later years.

One approach to liability computation applies the same discount rate to all future payments regardless of when they occur. This approach produces inaccurate liability estimates because it ignores a basic reality of financial markets: that the rate of interest earned on an investment or paid on a loan varies with the length of time of the investment or the loan. If a consumer goes to a bank to buy a Certificate of Deposit, he will expect to receive a higher rate on a five-year CD than on a one-year CD. Likewise, that same consumer who borrows money to buy a house expects to pay a higher interest rate for a 30-year than a 15-year mortgage.

Pension discount rates must recognize this simple financial reality. Pension payments due next year should be discounted at a different, and typically lower, rate than payments due 20 years from now. Why is this important? Pension plans covering mostly retired workers that use a 20-year interest rate to discount all their benefit payments will understate their true liabilities. This will lead to plan underfunding that could undermine retiree pension security, especially for workers who are nearing retirement age. Proper matching of interest rates to payment schedules cannot be accomplished using any single discount rate.

Computing liabilities by matching interest rates on zero-coupon bonds that mature on the same date that benefit payments are due is not complicated. Once expected pension cash flows are calculated by the actuary it is no more difficult to discount benefit payments on a spreadsheet with an array of different interest rates than it is if only one discount rate is used.

It is also important to understand that the discount rate used does not change the actual obligation - the liability is what it is. Choosing the proper discount rate gives us an accurate measure in today's dollars of future benefit payments; it does not change those payments. But if we don't measure that value properly today, plans may not have sufficient funds set aside in the future to make good on those pension promises.

The Administration proposes that benefit payments made in future years be discounted to today's dollars using discount rates taken from a corporate bond yield curve (a table or graph that illustrates the interest rates on bonds that mature at different dates in the future). Liabilities would be computed by using interest rates on bonds that mature on a specific date in the future to discount benefit payments due to be made that same year.

Furthermore, implementation of the yield curve would be phased in over five years. The phase-in would start with the use of a single long-term corporate bond rate as recommended in HR 1776 (proposed by Congressmen Portman and Cardin) for the first two years. In the third year a phase-in to the appropriate yield curve discount rate would begin. The yield curve would be fully applicable by the fifth year. 1

This phase-in period would provide some short term funding relief for sponsors, but achieve the desired level of accuracy at the end of five years.

3. *Pension discount rates should be based on current financial conditions.*

Pension liability computations should reflect the current market value of future benefit payments - this is a key component of accuracy. Plan sponsors and investors are interested in the current value of liabilities in order to determine the demands pension liabilities will place on the company's future earnings. Workers and retirees are interested in the current value of liabilities so that they can determine whether their plans are adequately funded.

Some argue that discount rates should be averaged (smoothed) over long periods of time. Under current law they are smoothed over four years. Such smoothing is intended to reduce the volatility of liability measures and helps make contribution requirements more predictable. Unfortunately current smoothing rules reduce the accuracy of liability measures while failing to achieve stability in annual contributions. Smoothing can mask changes in pension plan solvency of which workers and retirees should be aware. As I mentioned earlier, we would like to work with Congress to identify permanent reforms of the funding rules that would reduce volatility in annual contributions, without the corollary effect of reducing measurement accuracy.

The Administration proposes to decrease smoothing gradually during the 5 year phase-in. In years one and two, four year smoothing is maintained. Smoothing is reduced in years three and four and finally, in year five, set at a 90-day moving average to eliminate the impact of day-to-day market volatility. This will provide an appropriately current measure of interest rates.

4. *Pension discount rates should apply to annuities and lump sum payments in a consistent and neutral manner.*

Retirees and departing workers in some plans can opt to receive a single payment for their pension benefits rather than regular payments over their lifetimes. The value of these so-called lump sum payments is the present value of the worker's expected retirement annuity. Using different discount rates for annuities and lump sums creates an economic incentive for choosing one form of payment over the other.

The Administration proposes that the yield curve used to measure pension liabilities also be used to compute lump sum payments so as to reflect accurately the life expectancy of retirees in the amounts that they will receive. In order to minimize the disruption of plans of workers who will receive benefits in the immediate future, lump sums would be computed using the 30-year Treasury rate as under current law in years one and two. In the third

year a phase-in to the appropriate yield curve discount rate would begin. By the fifth year lump sums will be computed using the yield curve.

Workers receiving lump sums, especially those in their 50's, 60's and older, would be better off under the Administration proposal than under an alternative that would compute lump sums using a single long term corporate interest rate. Workers electing lump sums at relatively younger ages would have a higher proportion of their future payments discounted at long-term interest rates than workers retiring at relatively older ages. This is appropriate given the different time frames over which they had been expecting to receive their benefits. While moving from the 30-year Treasury rate to any corporate bond based rate will result in lower lump sum payments for younger workers who leave their jobs, under the yield curve approach older workers closer to retirement age will be little affected by the change.

However, some workers who will soon be leaving their jobs have been anticipating taking their pension benefits in the form of a lump sum with the expectation that those benefits would be computed using the 30-year Treasury rate. Computing lump sums using the yield curve rather than the 30-year Treasury rate may result in lower lump sum payments for those who leave at a young age. The Administration proposal is for the benefits of younger and older workers alike to be consistently and accurately valued, whether a lump sum or a traditional annuity benefit.

Concluding Observations

In closing I would like to make a few general observations about the Administration's proposed permanent discount rate for pension liabilities.

Because discounting pension payments using a yield curve is already considered a best practice in financial accounting, large sponsors are almost certainly making these computations now or know how to make them.² Sponsors certainly know what their expected future pension cash flows are.

The mechanics of discounting future pension cash flows are in fact quite simple. This is true whether one uses a single rate to discount all payments or uses different rates to discount payments made in each year. Such calculations, which can be done with a simple spreadsheet, should not pose serious problems even for small plans let alone plans sponsored by large, financially sophisticated firms.

Yield curves used to discount pension benefit payments have been available for a number of years. One example of such a pension yield curve is the one developed by Salomon Brothers in 1994 for the Securities and Exchange Commission. Monthly Salomon Brothers yield curves dating back to January 2002 can be found on the Society of Actuaries web site at <http://www.soa.org/sections/pendis.html>. We envision that the Treasury Department would adopt a similar methodology. Using this widely accepted approach, we would develop and publish a yield curve reflecting interest rates for high-quality zero-coupon call adjusted corporate bonds of varying maturities.

The adjustments that we would anticipate making - through a rulemaking process subject to public comment - would only be to reflect accurately the time structure of the yield curve. The procedure we envision would involve two types of adjustments: (1) standardizing the corporate rates as zero coupon, call adjusted rates; and (2) extrapolating the shape of the corporate yield curve using the shape of the Treasury yield curve because of the thinness of the market for corporate bonds of some durations, especially long-term bonds. The yield curve rates would not be adjusted to reflect expenses, mortality or any other actuarial or administrative concerns. The high-grade corporate rates used to construct the curve will only be adjusted so that they accurately reflect the time structure of benefit payments.

As I mentioned, the Treasury would undertake this process using a formal notice and comment rulemaking process to ensure market transparency and to incorporate input from all interested parties in final development of the yield curve. Although the groundwork is well established, we certainly plan to work with all stakeholders to finalize the methodological details of the ultimate yield curve.

While we believe that important near-term considerations warrant beginning the transition by allowing plans to use a long-term corporate bond index for the first two years, staying there would result in greater underfunding over time than we face today. Such an outcome would be counterproductive and harmful, and would certainly move the defined benefit system in the wrong direction. Most importantly, it would put workers' pensions at greater risk.

Some have alleged that there would be adverse macroeconomic consequences to using a yield curve. Such critics allege that the economy would suffer because the resulting increased pension contributions would deplete funds from the economy. That argument is, we submit, incorrect. A firm's pension contributions are invested by the plan for the future benefit of the plan's participants. Those contributions go right back into the economy as savings. They are not withdrawn from the economy. Pension funds are a significant source of capital investment in our economy-investment that creates jobs and growth. And again, an accurate measurement of liabilities is necessary to ensure appropriate funding of pension promises to America's workers.

The macroeconomic effect we should be worried about is that which would result if plan sponsors failed to fund the pension promises that America's workers are depending upon for their retirement security. This is why the Administration is urging that pension liabilities be accurately measured and why we intend to provide Congress with further recommendations to fix the pension funding rules. Only if our pension liabilities are accurately measured will we be able to have an informed dialogue about such comprehensive reforms.

Some have alleged that this proposal would place sponsors of plans with older workforces at a disadvantage by requiring them to put more money into their plans than they would under alternative proposals. The fact of the matter is that more money is needed in those plans to ensure that older workers receive the benefits they have earned through decades of hard work. These obligations of employers to our older workers exist whether our measurement system accurately recognizes them or not. We think that older workers have the same right to well funded pensions that younger workers have and that they should not be systematically disadvantaged by the funding rules.

Finally, we should also not overlook other positive consequences of more accurate pension liability measures. We live in an era when Americans are rightly demanding increased accuracy and transparency in corporate accounting. Surely this is the standard we should pursue for the pension systems on which Americans' workers depend. Uncertainty about the size of pension liabilities has negative effects on sponsor stock prices. Increased accuracy of pension liability measurement will greatly reduce that uncertainty when such measures become available to the public under the enhanced disclosure measures that we are proposing. We see all of these recommendations as working together to clarify our pension funding challenges, better informing the public, employers and policy makers about what must be done to ensure adequate worker retirement security.

As I stated at the outset, the Administration's permanent discount rate replacement proposal is designed to strengthen American's retirement security by producing accurate measures of pension liabilities. And accurate measurement is the essential first step in ensuring that pension promises made are pension promises kept.

1- In years 1 and 2 pension liabilities for minimum funding purposes would be computed using a discount rate that falls within a corridor of between 90 and 105 percent of a 4 year weighted average of the interest rate on a long-term highly-rated corporate bond. In years 3 and 4, pension liabilities would be an average of that calculated using a long-term corporate rate and that using a yield curve. In year 3, the corporate rate would receive a 2/3 weight and the yield curve a 1/3 weight. In year 4 the weights would be switched and in year five liabilities would be computed using the yield curve.

2- See Financial Accounting Standard 87.