Testimony of J. Mark Iwry[1]

Before the Subcommittee on Financial Management, the Budget, and International Security
Committee on Governmental Affairs
United States Senate

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Chairman Fitzgerald, Ranking Member Akaka and members of the Subcommittee, I appreciate the opportunity to appear before you to discuss issues relating to the current underfunding in our private defined benefit pension system and the role and financial situation of the Pension Benefit Guaranty Corporation.[2]

I. Background

A. Defined Benefit Plans and the PBGC

The Pension Benefit Guaranty Corporation (PBGC), a federal government corporation created under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), provides insurance to protect the retirement benefits of most participants in tax-qualified defined benefit plans when the plan terminates while inadequately funded and the plan sponsor has failed or is otherwise demonstrably unable to make up the deficiency. The PBGC guarantees about 33,000 defined benefit plans sponsored by private-sector employers and covering 44 million workers and retirees.

The PBGC pays statutorily-defined guaranteed pension benefits to participants monthly up to specified dollar limits (currently just under $44,000 for pensions beginning at age 65; less for pensions beginning earlier). This PBGC guarantee applies only if a defined benefit plan terminates without adequate funding to pay the benefits and the employer goes out of business or is otherwise financially unable to fund the benefits (a "distress termination"). In that event, the PBGC generally steps in and takes over trusteeship of the plan and its assets, assuming responsibility for paying guaranteed benefits. In addition, in appropriate circumstances, the PBGC may obtain a court order to involuntarily terminate a plan that the employer has not terminated. Following a distress or involuntary

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[1] The witness is a lawyer and a Nonresident Senior Fellow at the Brookings Institution. He served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. The views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] Because I have been asked to address some of these issues in congressional testimony in the past, sections I.B, V.I, and certain other portions of this testimony draw heavily on my previous testimony (including some passages drawn verbatim from the previous testimony).

termination, the plan sponsor and its affiliates are liable to the PBGC for unfunded liabilities, and the PBGC may place a lien on the sponsor's property for up to 30% of its net worth. An employer that is financially capable of fully funding a plan's benefits when the plan terminates is required to do so (in a "standard termination").

In a sense, the PBGC operates as an insurance company for pension plans. However, it has a special public responsibility to protect the interests of plan participants. The agency has often acted as an advocate for participants' pension interests in negotiating with corporations that are in financial distress regarding pension plan funding and benefits in connection with corporate bankruptcy.

The PBGC maintains separate insurance programs for "single employer" plans and "multiemployer" plans, covering about 34.4 million and about 9.5 million employees and retirees, respectively. The former category includes the conventional corporate plan sponsored by a single employer for its employees (as well as a plan sponsored by several related employers but where the joint sponsorship is not pursuant to collective bargaining). The latter type, the "multiemployer" plan, is sponsored by related employers in a single industry where employees are represented by collective bargaining and where the plans are jointly trusteed by representatives of corporate management and of the labor union. The legal frameworks are somewhat different for the two types of plan.

Defined benefit plans cover employees of private-sector and public-sector employers. Plans maintained by State and local governments (and by the Federal Government) for their employees comprise a large portion of the defined benefit universe but are generally exempt from ERISA and are not covered by PBGC termination insurance.

The PBGC is funded in part by insurance premiums paid by employers that sponsor defined benefit pension plans. All covered single-employer plans pay a flat premium of $19 per plan participant. Single-employer plans that are considered underfunded based on specified assumptions are subject to an additional variable premium of $9 per $1,000 of unfunded vested benefits. PBGC's other sources of funding are assets obtained from terminated plans it takes over, recoveries in bankruptcy from former plan sponsors, and earnings on the investment of its assets. General tax revenues are not used to finance the PBGC, and it is not backed by the full faith and credit of the United States Government. The US Government is not liable for any liability incurred by the PBGC.

B. Taxpayers' Current Investment in Private Pensions

It is often observed that if the defined benefit pension funding problem becomes severe enough, PBGC might eventually become unable to pay insured benefits as they come due, and a federal taxpayer bailout might be necessary. By way of context, it is worth recalling that the taxpayers already are partially subsidizing the private pension system, including defined benefit plans, through federal tax preferences for pensions.

Those tax preferences represent a significant investment by the taxpayers. The Treasury Department has estimated the cost of the tax-favored treatment for pensions and retirement savings – the amount by which the pension tax advantages reduce federal tax revenues -- as having a present value of $192 billion.[3] Of that total, some $100 billion is attributable to defined benefit plans and defined contribution plans other than section 401(k) plans (and the remainder is attributable to 401(k) plans and IRAs).[4]

This present-value estimate is designed to take into account not only the deferral of tax on current contributions and on earnings on those contributions but also the tax collected when the contributions and earnings are distributed in the future, whether within or beyond the "budget window" period.[5] Because large portions of the defined benefit plan universe are in each of the private sector and the public (mainly state and local government) sector, a significant percentage of the tax expenditure for non401(k) pensions is attributable to the plans in each of those sectors.

II. Recent Developments Affecting Pension Funding and Pension Insurance

After running a deficit for the first 21 years of its history, the PBGC's single-employer program (which accounts for the vast majority of PBGC's assets and liabilities) achieved a surplus from 1996 through 2001. By 2000, the surplus was in the neighborhood of $10 billion. Recently, however, the PBGC has seen the financial condition of its single-employer program suddenly return to substantial deficit ($3.6 billion in 2002 and an estimated $5.4 billion at the end of March 2003).

This has occurred because a number of major plan sponsors in financial distress have terminated their defined benefit plans while severely underfunded, while others appear likely to follow suit. (Low interest rates, increasing the valuation of plan liabilities, and low returns on investment, reducing plan assets as well as PBGC's own assets, have also contributed to the problem.) PBGC estimates that its losses might ultimately include an additional $35 billion of unfunded vested benefits that the agency would have to take over if certain plans maintained by financially weak employers (including airlines) were to terminate.

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[3] Pensions can be viewed as increasing national saving to the extent that the saving attributable to pensions (net of any associated borrowing or other reductions in other private-sector saving) exceeds the public dissaving attributable to the tax preferences for pensions.

[4] Budget of the U.S. Government, Fiscal Year 2004, Analytical Perspectives, Table 6-4, page 112 ("FY 2004 Budget, Analytical Perspectives"). The budget documents also contain other tax expenditure estimates that are based on alternative methods.

[5] FY 2004 Budget, Analytical Perspectives, page 102.

As a result, the General Accounting Office has recently placed PBGC's single-employer insurance program on its high-risk list of federal agencies with significant vulnerabilities.[6]

To help put the amounts into perspective, the total amount of pension benefits PBGC insures is approximately $1.5 trillion, and PBGC estimates that total underfunding in the single-employer defined benefit system amounted to more than $400 billion as of the end of 2002. (Before 2001, the previous high water mark in underfunding had been little more than one fourth of that amount, in 1993.) Of the $400 billion, the $35 billion figure cited earlier represents underfunding in plans sponsored by financially troubled companies where PBGC estimates that plan termination is reasonably possible. PBGC has also stated that, by the end of FY 2003, the $35 billion could become $80 billion or more.

The downturn in the stock market during the past several years, unusually low interest rates, and the Treasury Department's buyback of public debt and decision to stop issuing 30-year Treasury bonds have contributed in a major way to converting defined benefit plan surpluses into deficits. Significant underfunding has developed because plan asset values have fallen below their levels during the late 1990s, while the present value of plan liabilities has increased because the four-year weighted average of interest rates on 30-year Treasury bonds, used as a basis for valuing defined benefit liabilities, has been at an unusually low level.

The greater likelihood of corporate failures associated with the weak economy also has contributed significantly to this situation. PBGC estimates that half of the underfunding in financially weak companies is attributable to two industries: steel and airlines, which together account for nearly three fourths of all past claims on the PBGC while representing less than 5% of participants covered by PBGC.[7] For example, in 2002, PBGC involuntarily terminated a plan of Bethlehem Steel Corporation that shifted about $3.7 billion of unfunded liabilities to the PBGC. (Reportedly, the plan had been 97% funded as recently as 1999, dropping to 45% by 2002.)

In addition, a fundamental demographic trend has raised the cost of funding defined benefit plans, making them harder to afford: increased longevity combined with earlier retirement. It has been estimated that the average male

[6] However, the PBGC's assets in the single-employer program exceeded $25 billion as of September 30, 2002 (and are greater now). For some time to come, these assets will be more than sufficient to meet PBGC/s current benefit payment obligations and administrative expenses – currently $2 to 3 billion per year, offset in part by premium income approaching $1 billion a year..

[7] Most of the financial data in this testimony regarding PBGC and its exposure are from PBGC testimony earlier this month:Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the U.S. House of Representatives Committee on Education and the Workforce, September 4, 2003.

worker spent 11.5 years in retirement in 1950, compared to 18.1 years today.[8] Of course longer retirements increase plan liabilities because the life annuities provided by defined benefit plans are paid for a far longer period.

The increased longevity and retirement periods also mean that the single-sum payments many of these plans offer ("lump sum distributions") are significantly larger, as they generally are based on the actuarial present value of the life annuity. Combined with this is the separate tendency of an increasing number of defined benefit plans to offer and pay lump sums either at retirement age or at earlier termination of employment, or both. The effect is to accelerate the plan's liability compared to an annuity beginning at the same time.

Another trend adversely affecting the system and the PBGC is the gradual decline of defined benefit pension sponsorship generally. (I have discussed a number of the major factors accounting for the decline in testimony on June 4, 2003 before the House Committee on Education and the Workforce, Employer-Employee Relations Subcommittee.) One effect of the overall decline is the increasing risk that financially stronger plan sponsors will exit the defined benefit system, recognizing their exposure to the "moral hazard" of dying companies adding benefits that they know may well be paid by the PBGC. This risk grows as the premium base narrows and financially stable sponsors find their premiums are increasingly subsidizing the financially weak employers that pose the risk of underfunded plan terminations imposing liability on the PBGC.

Combined with these developments is a fundamental structural problem and growth in the scale of the issue. As economic adversity has hit certain industries and companies, and as their ratio of active employees to retirees has dwindled, unfunded pension obligations (as well as other unfunded "legacy costs", chiefly retiree health liabilities) loom larger in the overall financial situation of individual companies and entire industries.

When the pension insurance system was enacted as part of ERISA in 1974, plan liabilities typically were not large relative to plan sponsors' market capitalizations. However, during the ensuing 29 years, pension and retiree health obligations have grown relative to assets, liabilities and market capitalization of the sponsoring employers (and some financially troubled companies have pension underfunding significantly in excess of their market capitalization).

Moreover, contrary to what might have been the prevalent expectations in 1974, these economic troubles and associated underfunding have come to affect not only individual companies but entire industries. In view of these fundamental structural developments, the issue is no longer only a pension policy problem; it has become a larger industrial and social policy problem.

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[8] Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the U.S. House of Representatives Committee on Ways and Means, Subcommittee on Select Revenue Measures, April 30, 2003, pages 7-8.

These developments have been saddling plan sponsors with funding obligations that are large and -- in the case of the unusually low interest rates and low equity values -- sudden. These obligations in turn are hurting corporate financial results. As a result, while some have noted that recent poor investment performance in 401(k) plans should give employees a new appreciation of defined benefit plans, some corporate CFOs have been viewing their defined benefit plans with fresh skepticism. The prospect that more defined benefit plans will be "frozen" (ceasing further accruals under the plan) or terminated is a very real concern. Congress must take it seriously.

Defined benefit plans have provided meaningful lifetime retirement benefits to millions of workers and their families. They are a central pillar of our private pension system. National retirement savings policy should seek to avoid a major contraction in the defined benefit pension system while protecting the security of workers' pensions through adequate funding.

III. Guiding Principles to be Reconciled in Formulating Policy

As suggested, a number of often conflicting public policy objectives need to be balanced in responding to this situation. They include the following:

- Provide for adequate funding over the long term to protect workers' retirement security, with special attention to reducing chronic underfunding.

- Take into account the potential impact of very large funding demands on a plan sponsor's overall financial situation and on economic growth (which may suggest, among other things, close attention to appropriate transition rules).

- Minimize funding volatility for plan sponsors so that required increases in funding from year to year are kept on a reasonably smooth path.

- Protect the reasonable expectations of employees and retirees with respect to promised benefits, and, to the extent possible, avoid discouraging the continued provision of benefits. (This may suggest an emphasis on requiring sponsors to fund adequately in preference to direct restrictions on their ability to provide benefit improvements or curtailment of the PBGC's guarantee.)

- Do not penalize the plan sponsors that are funding their plans adequately and that are not part of the problem. Minimize any impact on those sponsors and, more generally, encourage employers to adopt and continue defined benefit pension plans.

- To the extent possible, avoid rules that are unnecessarily complex or impractical to administer.

- Be mindful of the impact of rule changes on the federal budget deficit.

IV. Threshold Questions

Balancing these objectives is exceedingly difficult. In considering how best to do so, it is worth addressing two threshold questions.

First, should the situation be allowed to right itself without legislation? Are the problems affecting pension funding and the PBGC's finances so clearly cyclical that they can reasonably be expected to solve themselves with continued economic recovery, rise in equity values, and rise in interest rates?

In my view, the answer is no. Plan sponsors need some degree of short-term, temporary funding relief now, largely because of the distortions in the level of the 30-year Treasury discount rate. As noted, that rate has been unusually low, affected by buybacks and Treasury's decision to discontinue issuance of the 30-year Treasury bond. Accordingly, the temporary relief enacted for 2002 and 2003 in the Job Creation and Worker Assistance Act of 2002 should not be allowed to expire at the end of this year without an appropriate legislative replacement.

A second threshold question is whether other, permanent changes should be made to the defined benefit funding and insurance system. Here as well, I believe Congress needs to act, although not this year. It is important for the system to transition from temporary funding relief in the short term to an improved, stronger and less volatile funding regime in the medium and longer term, including a broader policy approach to the industry-wide problem of large underfunded legacy costs.

V. Specific Cautions and Considerations

The major statutory reforms of 1986, 1987 and 1994 have left the system in far better condition than would otherwise have been the case. But significant unfinished business remains. In large part, it is unfinished because it has proven exceedingly difficult to accomplish. Important policy objectives and values are in sharp tension with one another, as discussed. Accordingly, Congress needs to proceed with caution, after thorough analysis, to adjust the funding and related rules in a way that carefully balances the competing considerations. The remainder of this testimony suggests a number of specific cautions and considerations.

A. Plan Sponsors Need Protection from Funding Volatility

It is hard to improve funding in underfunded plans without jeopardizing some plan sponsors' financial stability. Sudden, large funding obligations can push a company over the edge, threaten its access to credit, or prompt management to freeze the plan (i.e., stop further accruals). The current situation – in which short-term relief is needed -- makes it harder still. This is because funding relief generally does not actually reduce the amount the plan sponsor must ultimately pay, as opposed to merely postponing payment. The promised plan benefits are what they are, regardless of the funding rules, and must be paid sooner or later (absent a distress termination).

Accordingly, if short-term relief went too deep or lasted too long, it would put off the day of reckoning, and could cause greater volatility when the temporary relief expired. This could make it harder to implement the necessary longer-term strengthening of pension funding in a gradual manner to minimize volatility and enable plan sponsors to engage in appropriate advance budgeting.

B. Avoid Penalizing the Plan Sponsors That Are Funding Adequately

Plans of financially healthy companies, even if underfunded, do not present a risk to the PBGC or the participating employees so long as the company continues healthy and continues to fund the plan. To attempt to close the premium shortfall by imposing heavy premiums on healthy plan sponsors would tend to discourage those companies from adopting or continuing to maintain defined benefit plans.

Because the financially stronger defined benefit plan sponsors with adequately funded plans are effectively subsidizing the pension insurance for the weaker ones, there is already a risk, as noted, that the stronger employers will exit the system, leaving a potentially heavier burden to be borne by the remaining premium payers or ultimately by the taxpayers. This risk would be exacerbated to the extent that the subsidy from stronger to weaker employers was increased.

Although the PBGC insures benefits in underfunded plans sponsored by insolvent employers, the PBGC premium structure takes into account only the risk of underfunding and not the risk of insolvency (and does not fully take into account even the risk associated with underfunding). Yet the PBGC has observed that a large proportion of the sponsors that have shifted their obligations to the PBGC in distress terminations had below investment-grade credit ratings for years prior to the termination. This leaves a major element of moral hazard in the insurance program. It is understandable, therefore, that the Administration is exploring whether it would be feasible and practical to better adjust the premiums to the risk by relating the level of premiums – or possibly funding obligations -- to the financial health of the company, as determined by an independent third party such as a rating agency.

C. Improve Transparency and Disclosure of Underfunding

Current law requires plan sponsors to report annually the plan's "current liability" and assets for funding purposes. The Administration has stated in testimony that "workers and retirees deserve a better understanding of the financial condition of their pension plans, that required disclosures should realistically reflect funding of the pension plan on both a current and a termination liability basis, and that better transparency will encourage companies to appropriately fund their plans"[9] (in part on the theory that employees will then be better equipped to press for such funding).

Accordingly, the Administration has proposed to require defined benefit plan sponsors to disclose in their annual summary annual report to participants the value of plan assets and liabilities on both a current liability basis and a termination liability basis. In general, a plan's current liability means all liabilities to participants accrued to date and determined on a present value basis, on the assumption that the plan is continuing in effect. By contrast, termination liability assumes the plan is terminating, and, according to PBGC studies, is typically higher because it includes costs of termination such as "shutdown benefits" (subsidized early retirement benefits triggered by layoffs or plant shutdowns) and other liabilities that are predicated on the assumption that participants in a terminating plan will tend to retire earlier. This is often the case because, when the PBGC takes over a terminating plan, the employer typically has become insolvent or at least has "downsized" significantly.

In addition, the Administration has proposed public disclosure of the special and more timely plan asset and liability information -- the underfunded plan's termination liability, assets, and termination funding ratios -- that sponsors of plans with more than $50 million of underfunding are currently required to share with the PBGC on a confidential basis.

Improved transparency and disclosure is desirable.[10] Plan sponsor representatives have raised concerns, however, about the cost of generating these additional actuarial calculations and about the risk that these disclosures would confuse or unnecessarily alarm participants in plans sponsored by financially strong employers that are able to pay all benefits in the event of plan termination. As noted earlier, Congress should be slow to impose additional costs on sponsors of defined benefit plans that do not present the greatest risks to the PBGC or participants. It is worth considering, therefore, whether such additional disclosure requirements should be limited to sponsors that are

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[9] Testimony of Ann L. Combs, Assistant Secretary for Employee Benefits Security, U.S. Department of Labor, before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce and the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, July 15, 2003 ("Combs testimony"), page 5.

[10] Generally similar requirements have been proposed in legislation just introduced in the House by Reps. Miller, Doggett and others.

financially vulnerable and arguably present some risk of being unable to pay all benefits upon plan termination.

D. Protect Against "Moral Hazard" in Ways That, to the Extent Possible, Protect Workers' Reasonable Expectations and Allow for the Provision of Continued Benefits

The Administration has put forward several proposals to address the "moral hazard" associated with the current system of pension funding. As stated in the Administration's testimony, a defined benefit plan sponsor "facing financial ruin has the perverse incentive to underfund its … plan while continuing to promise additional pension benefits. The company, its employees, and any union officials representing them know that at least some of the additional benefits will be paid, if not by their own plan then by other plan sponsors in the form of PBGC guarantees. Financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they must eventually fund them."[11] In addition, a company in economic distress that is strapped for cash might be tempted to respond to pressure for some kind of compensation increase by increasing pension promises rather than providing an immediate pay raise. And employers faced with collective bargaining pressures have often been reluctant to overfund the bargained plan.

To address this longstanding problem, the Administration has proposed to require plan sponsors that have below investment grade credit ratings (or that file for bankruptcy) to immediately and fully fund any additional benefit accruals, lump sum distributions exceeding $5,000, or benefit improvements in plans that are less than 50% funded on a termination basis, by contributing cash or providing security.[12] Thus, continued accruals, lump sum distributions of more than $5,000, and benefit improvements would be prohibited unless fully funded by the employer.

These measures – particularly a freeze of benefit accruals -- need to be weighed carefully and cautiously. First, an empirical question: to what extent are underfunded plans covering hourly paid workers in fact amended to increase benefits in the expectation that the employer might well be unable to ever fund the additional benefits, and that the PBGC will ultimately assume the obligations?

In addressing this question, it is relevant to recall the differences between two common types of defined benefit pension plans: plans that use a benefit formula based on the employee's pay and so-called "flat benefit" plans, which, in mature industries, account for a large proportion of the actual and potential claims on PBGC's guarantee.

[11] Combs testimony, pages 6-7.

[12] The Administration's proposal would go significantly beyond current law, which requires sponsors of plans that are less than 60% funded on a "current liability" basis to immediately fund or secure any benefit increase exceeding $10 million.

Pay-based or salary-based plans commonly express the employee's pension benefit as a multiple of final pay or career average pay for each year of service for the employer (for example, the annual pension benefit might be 1.5% of the employee's final salary, averaged over the last few years of the employee's career, times years of service). This type of formula – typical in defined benefit plans for salaried workers -- has the effect of increasing the amount of benefits automatically as salary typically rises over time and over the course of an employee's career. This tends to protect salaried employees' pensions from the effects of inflation and to maintain retirement income at a targeted replacement rate relative to the active employee's pay. The plan sponsor projects and funds for the expected increases in pay over the employee's career.

By contrast, flat benefit plans have pension benefit formulas that are not based on salaries or wages – such as a formula for an hourly-paid workforce that expresses the pension benefit as a specified dollar amount per month multiplied by the employee's years of service. Many collectively bargained plans are designed as flat benefit plans in order that the amount of the pension benefit not vary among employees based on differences in pay levels but only based on differences in length of service. Typically, the monthly dollar amounts are increased every three or five years when labor and management renegotiate union contracts because – unlike a pay-based plan formula -- benefit increases do not occur automatically as pay rises.

Typically, the negotiated increases to benefit levels apply not only to future years of service but to past years as well. This accounts for part of the funding problem affecting bargained flat benefit plans: it often is hard for funding to "catch up" with the rising benefit levels because new layers of unfunded benefits attributable to past service are often added before the employer has funded all of the previous layers.

On the other hand, without periodic formula improvements, the fixed hourly benefit would be exposed to inflation and could represent a diminishing portion of the employee's pay over time. Accordingly, many hourly plan benefit improvements can be likened to the automatic salary-driven increases inherent in a salary-based formula, which are designed to meet employees' reasonable expectations regarding the level of post-retirement income replacement. Some would argue, therefore, that hourly plan benefit improvements, at least to the extent they do not exceed an amount that reasonably serves this updating function, should not be subjected to special premiums, guarantee limitations, or funding strictures that might be proposed for other types of benefit improvements in underfunded plans.

Second, new rules in this area need to take into account the extent to which the PBGC remains exposed to benefit improvement claims in corporate "death spiral" situations even after application of the five-year phasein of its guarantee.

(PBGC's guarantee of new benefits provided by a plan amendment that has been in effect for less than five years before a plan termination generally is phased in ratably, 20% a year over five years.)

Third, formulation of policy here should take into account the fact that the employees participating in underfunded plans generally do not control either the funding or their employer's financial condition. To what extent should they suffer the consequences of the employer's failure to fund adequately or the employer's financial weakness? As noted, some would argue that restricting flat benefit plan improvements that essentially reflect wage or cost of living increases would unduly interfere with employees' reasonable expectations regarding their promised retirement benefits. (Some would contend that such restrictions would unduly interfere with collective bargaining as well.) Of course this would be even more true of a mandatory freeze of continued accruals at existing benefit levels or a suspension of lump sum payments above $5,000. Requirements to immediately fund or secure benefits can also discourage an employer from increasing benefits if it is willing and able to fund the increase over time but unwilling or unable to secure or fund it immediately.

<u>E. Allow Funding to Take Into Account Expected Lump Sum Benefits</u>

Current IRS rules restrict the ability of a plan sponsor to fund based on expected future lump sum distributions even when those would impose larger obligations on the plan than annuity distributions. Instead, employers are required to fund based on the assumption that all employees will choose annuities, even when that assumption is unrealistic. In the interest of more accurate funding, the rules should be changed to allow employers to anticipate funding obligations associated with expected lump sums.

<u>F. Beware of Unduly Restricting the Size of Benefit Payments in the Interest of Funding Relief</u>

For an employer, funding is a long-term, aggregate process involving obligations to numerous employees coming due over a period of years. Oftentimes, the employer can manage its risk over time, by adjusting to temporary shortfalls, funding demands, and other changes so that the ebbs and flows can even out in the long run. For an employee, however, determining the amount of the pension ordinarily is a one-time, irrevocable event, especially in the case of a single-sum distribution. If, for example, Congress provided funding relief in the short term by increasing the funding discount rate, and applied a higher discount rate to the calculation of lump sums in a way that unduly reduced their value, employees who received those reduced lump sum distributions during a temporary relief period would suffer irrevocable consequences.

Congress could respond to further developments and experience affecting plan funding by revisiting and readjusting the discount rate and related rules, and employers could adjust accordingly. But employees who received a reduced lump sum in the interim would presumably have incurred a permanent reduction relative to the higher value the employee might reasonably have expected, without any opportunity to adjust or recoup the shortfall. Accordingly, a higher discount rate used to provide temporary funding relief should not automatically be applied to determine the lump sum equivalent of an annuity under the plan.

G. Don't Discourage Defined Benefit Plan Investment in Equities

Defined benefit plans should not be precluded or discouraged from continuing to be reasonably invested in equities. Defined benefit plans in the aggregate reportedly have been more than 60% invested in US and international stocks. It is evident that many plan sponsors have come to view stocks, as well as real estate and other assets that are not fixed income securities, as playing an important role in their investment portfolios. They see investment of a substantial portion of defined benefit plan assets in diversified equities as consistent with the duties ERISA imposes on fiduciaries to invest prudently, in a diversified manner, and to act in the best interests of plan participants.

Of course stocks generally are expected to generate higher expected returns, together with greater risk or volatility, than a dedicated portfolio of bonds whose maturities match the durations of the plan's benefit payment obligations. Accordingly, over the long term, many view reasonable investment in equities as consistent with good pension policy –likely to produce higher investment returns that will benefit plan sponsors and, ultimately, participating employees. Any changes to the funding or premium rules that may be intended to take account of the additional risk associated with equities should be crafted with care to avoid penalizing or discouraging defined benefit plan investment in a reasonable portfolio of diversified equities.

H. Be Cautious of Piecemeal Reforms

The pension funding rules are complex and interrelated. Accordingly, it generally is desirable to develop permanent reforms in a comprehensive manner, as opposed to enacting piecemeal changes to interdependent elements of the system. For example, the valuation of plan liabilities is affected by a set of actuarial assumptions, including a discount rate, mortality and expected retirement assumptions. Each of these represents a simplifying assumption about the amount and timing of a complex and inherently uncertain array of benefit obligations. For purposes of long-term reform, it generally is preferable to consider possible changes to the discount rate – including any trailing averages or other smoothing or averaging mechanisms and any minimum and maximum rates -- in conjunction with possible changes to the mortality tables, the rates at which plan sponsors are required or permitted to amortize their obligations, the funding levels that trigger accelerated funding and other obligations, and the funding levels above which employers cannot make tax-deductible contributions.

In particular, the crucial objective of controlling volatility in funding is harder to pursue through piecemeal changes that fail to take into account the entire fabric of rules confronting the plan. For example, an effort to smooth in one place might interact with other rules so as to create a sharp discontinuity elsewhere.

I. Clarify the Rules Governing Cash Balance and Other Hybrid Plans

Hybrid plans, such as cash balance pension plans, are plans of one type – defined benefit or defined contribution – that also have some characteristics of the other type. Currently, a major portion of the defined benefit universe takes the form of cash balance or other hybrid plans, as hundreds of sponsors of traditional defined benefit plans have converted those plans to cash balance formats in recent years. However, the precise application of the governing statutes to such hybrid plans has been the subject of uncertainty, litigation and controversy.

While only collaterally relevant to the pension funding issue, I believe that the overall defined benefit system would benefit considerably from a resolution of the cash balance controversy that would settle the law governing those plans in a reasonable way. While testifying earlier this summer before the House Education and Workforce Committee's Subcommittee on Employer-Employee Relations, in response to a question from a Member of the Subcommittee, I indicated that I believed Congress could resolve the cash balance controversy in a manner that reasonably protects older workers from the adverse effects of a conversion while allowing employers reasonable flexibility to change their plans. At that Subcommittee's request, I submitted additional written testimony illustrating such a legislative approach. If any Member of this Subcommittee is interested in the specifics, I would be happy to elaborate and to provide a copy of that testimony.[13]

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A Somewhat Personal Note

About a decade ago, the PBGC, together with the Departments of the Treasury, Labor, and Commerce, as well as representatives of OMB, the Council of Economic Advisers, the White House staff and others launched an intensive interagency process to review and reform the funding and pension insurance rules. This process, strongly encouraged by then Congressman Pickle, entailed research, fact-finding, modeling, economic, legal and legislative analysis. Input was solicited from management, organized labor, the financial services industry, other service providers, and other stakeholders in the private pension system, and a serious attempt was made to forge consensus among the various interests.

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[13] Testimony of J. Mark Iwry before the U.S. House of Representatives, Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003.

After months of work in 1993-94 involving several interagency meetings per week under the outstanding leadership of the late Martin Slate, then Executive Director of the PBGC, the Executive Branch made legislative recommendations to reform the funding rules and pension insurance regime. These proposals became the Retirement Protection Act of 1994, enacted as part of the GATT legislation.

Marty Slate saw to it that the PBGC's management processes were significantly improved and that its capacity to intervene in corporate transactions to protect workers' pension security was expanded and actively exercised. Within about two years after enactment of the GATT legislation incorporating the funding and insurance premium reforms, the budgetary deficit that PBGC had run for 21 years was reversed for the first time, and the defined benefit pension funding situation was improved.

Formerly Director of the Employee Plans Division at the Internal Revenue Service, Marty Slate was, as President Clinton characterized him, "the quintessential public servant." He was driven to achieve excellence and constructive results, and was dedicated to good government and to fairness of process and outcome. Those of us who worked with him in that major effort are the better for it, as is the private pension system. But political pressures and other constraints prevented that effort from accomplishing all that was needed to reform the system.

Now, after an additional decade of experience, it is time to build on that effort (and on the 1987 and earlier funding legislation that preceded it), and complete the unfinished business. Moreover, the scope of the problem has expanded over the past decade, largely because of the structural industry-wide and demographic developments outlined earlier. Fortunately, a number of the senior PBGC officials and other Executive Branch personnel who played an important role in that task force are involved in the current effort at the PBGC and the Treasury and Labor Departments, under the leadership of PBGC Executive Director Steve Kandarian, Under Secretary of the Treasury Peter Fisher, and Assistant Secretary of Labor Ann Combs, to develop comprehensive funding and pension insurance reforms. It is now up to them and others in the Executive Branch and in Congress to draw the appropriate lessons from 1993-94 and from the ensuing decade of experience.

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Mr. Chairman and Senator Akaka, I would be pleased to respond to any questions you and the Members of the Subcommittee might have.