Testimony of Assistant Secretary of Treasury Mark J. Warshawsky before the United States Senate Special Committee on Aging

Good afternoon Chairman Smith, Ranking Member Kohl and members of the Committee. I appreciate the opportunity to discuss the Administration's proposal to reform and strengthen the single-employer defined benefit pension system against the background of the larger issue of promoting national saving.

As far back as 1776, Adam Smith identified capital accumulation as the key force in promoting growth in the wealth of nations. Smith also identified the key force in capital accumulation: increasing national savings. Since Smith's time, almost all economists have come to understand the vital nature of national saving, and increasing saving has become a standard policy prescription for enhancing economic growth and raising living standards.

We know the U.S. faces a challenge as the economy works through the implications of the retirement of the Baby Boom generation. With the growth in the workforce set to slow and the average age of the population rising, maintaining steady growth in the standard of living will become more difficult. The Smith prescription shows the way out. Increase our savings, which will increase our accumulated capital, which will give each worker more and better tools to work with, which will raise productivity and secure a growing standard of living.

Despite the fact that this prescription is well-known, the evidence suggests it is exceptionally hard to follow. Net private saving (gross private saving less depreciation on plant, equipment, and housing stock) as a share of national income averaged about 11 percent from 1955 through 1985, but since then has trended steadily down. Over the past ten years, it has averaged about 5-1/2 percent of GDP, or about 5 percentage points below where it was during the decades of the 1950s, 60s, 70s, and most of the 80s.

One reason the saving prescription is difficult to follow is that incentives work against it. Our tax system, for example, has, for a long time, encouraged Americans to spend first and save second. To reverse, this, the Administration has worked hard to set in place the incentives that encourage saving. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut the top tax rates which raised the after-tax rate of return on capital income – encouraging savings. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) cut taxes on capital income.

But even with these positive changes, the Federal income tax code still discourages saving. To combat this, the President has proposed Retirement Savings Accounts, which would replace the complex array of retirement saving incentives currently in the tax code, such as IRAs, Roth IRAs, and similar saving vehicles. The President has also proposed Employer Retirement Savings Accounts to simplify the saving opportunities individuals have through their employers. The President's Lifetime Savings Accounts would, for the first time, allow individuals to save on a tax-preferred basis for any purpose. This can be especially important to low-income individuals and families who need to save, but cannot afford to lock up funds for retirement that may be needed for an emergency in the near-term. The President also proposed Individual Development Accounts that would give extra financial incentive to certain low-income families to set aside funds for major purchases, such as a first home.

Pensions also play a critical role in saving. Accumulating financial assets for future retirement is one of the main reasons households save at all. If individuals and households believe they will receive a pension in retirement, that influences their saving and asset accumulation behavior. If, in fact, those promised benefits not available because of pension underfunding, then the household's saving, and aggregate national saving, is less than it otherwise would have been had their pension been adequately funded.

I am pleased to have this opportunity to address you here today to discuss the Administration's pension reform proposal for single-employer defined benefit plans. Today I'll provide an overview of the pension reform proposal and describe how it fits into an agenda for enhancing national saving. I'll also address some recent criticism and discuss how, contrary to that criticism, the proposal is unlikely to have any negative short-term macroeconomic consequences.

The Administration's proposal

The single-employer defined benefit pension system is in serious financial trouble. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers. The insurance system protecting these workers in the event that their own pension plans fail has a substantial deficit. Such a deficit means that although the PBGC has sufficient cash to make payments in the near-term, without corrective action the insurance system ultimately will have inadequate resources to pay all future benefits owed to participants of failed plans. Currently, the PBGC is responsible for making benefit payments to more than one million participants of such plans.

The Administration believes that current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. These problems have been caused by the regulatory structure of the defined benefit system itself. Correcting these problems and securing the retirement benefits of workers and retirees requires that the system be restructured. If we want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system's regulatory structure to make it financially sound. Minor tinkering with existing rules will not be sufficient.

A defined benefit pension plan is a trusteed arrangement under which an employer makes a financial commitment to provide a reliable stream of pension payments to employees in exchange for their service to the firm. One cannot expect that such obligations will be honored consistently if they are allowed to remain chronically underfunded as they are under current law. The incentives for financially sound plan funding must be improved or we will continue to see pension plans terminating with massive amounts of unfunded benefits.

When pension plans default on their obligations participants often suffer lost benefits. For many retirees and near retirees these losses come at a time when they are unable to make up the shortfall through other means. In all cases, this Administration is committed to ensuring that pension promises made are pension promises kept. The goal of the Administration's proposed defined benefit pension reform is to enhance retirement security. The reforms are designed to ensure that plans have sufficient funds to meet accurately and meaningfully measured accrued obligations to participants and to ensure the financial solvency of the PBGC.

The current defined benefit pension funding rules – which focus on micromanaging annual cash flows to the pension fund -- are in need of a complete overhaul. These rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The current rules:

- Measure plan assets and liabilities inaccurately.
- Fail to ensure adequate plan funding.
- Fail to allow sufficient contributions by plans in good economic times, making minimum required contributions rise sharply in bad economic times.
- Permit excessive risk of loss to workers.
- Are burdensome and unnecessarily opaque and complex.
- Do not provide participants or investors with timely, meaningful information on funding levels.
- Do not generate sufficient premium revenues to sustain the PBGC.
- Create a moral hazard by permitting financially troubled companies with underfunded plans to make benefit promises they cannot keep.

The President's solution to these issues is to fundamentally reform the rules governing pension plan funding, disclosure and PBGC premiums, based on the following three simple principles:

- Funding rules should ensure pension promises are kept by improving incentives to fund plans adequately.
- Workers, investors and pension regulators should be fully aware of pension plan funding status.
- Premiums should reflect a plan's risk and ensure the pension insurance system's financial solvency.

Such changes will increase the likelihood that workers and retirees actually receive the benefits that they have earned and will moderate future insurance costs borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding.

Meaningful and Accurate Measures of Assets and Liabilities

Some argue that the best way to enhance retirement security is to create the appearance of well funded pension plans through the use of asset and liability smoothing and increased amortization periods for actuarial losses.

Our view is there are significant risks associated with masking the underlying financial and economic reality of underfunded pension plans. Failure to recognize risk because of the use of smoothing mechanisms results in transfers of risk among parties, in particular from plan sponsors to plan participants and the PBGC. One need only look at the losses incurred by many steel and airline plan participants and PBGC's net position to see this is so.

The first step in improving funding incentives, therefore, is to measure plan assets and liabilities accurately. We propose measuring liabilities on an accrual basis using a single standard liability measurement concept with minimal smoothing. The measure of accrued liability reflects whether plans are likely to remain ongoing or pose a risk of termination.

Ongoing liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay. Salary *projections* would not be used in determining the level of accrued benefits. Expected benefit payments would be discounted using the corporate bond spot yield curve that will be published by the Treasury Department based on market bond rates. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the *current liability* measure under current law, plans would be required to recognize expected lump sum payments in computing their liabilities.

At-risk liability measures liabilities that would accrue as a plan heads towards termination. At-risk liability would include accrued benefits for an ongoing plan, plus additional costs that arise when a plan terminates. These costs include acceleration in early retirements, increases in lump sum elections when available and the administrative costs associated with terminating the plan.

The following table provides a summary overview of the critical differences between the ongoing and at-risk liability assumptions.

	Ongoing Liability	**At-Risk Liability**
Discount Rate	------------- Yield Curve --------------	
Mortality Assumptions	------------- Set by Law --------------	
Retirement Assumptions	Developed using relevant recent historical experience.	Acceleration in retirement rates – individuals retire at the earliest early retirement opportunity.
Lump Sum Payments	Developed using relevant recent historical experience.	Acceleration in lump-sum election.
Transaction Costs	Not included	Included. Calculated by formula.

Under our proposal, asset values used in determining minimum required and maximum allowable contributions will be based on market prices on the valuation date. No smoothed actuarial values of assets will be used as they mask the true financial status of the pension plan.

One aspect of our liability measurement approach that has received a fair amount of attention is the use of the yield curve to discount pension plan liabilities. Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: they must reflect the timing of the future payments, and they should be based on current market-determined interest rates for similar obligations. The Administration proposes to replace the current law method with a schedule of rates drawn from a spot yield curve of high grade (AA) corporate bonds averaged over 90 business days. Discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability because, by matching the maturity of the discount rate with the timing of the obligation, it properly computes today's cost of meeting that obligation. Use of a yield curve is a prudent and common practice; yield curves are regularly used in valuing other financial instruments including mortgages, certificates of deposit, etc.

The Treasury Department has developed a corporate bond yield curve that is appropriate for this purpose. Our methodology allows spot yield curves to be estimated directly from data on corporate AA bonds. The process incorporates statistically unbiased adjustments for bonds with embedded call options, and allows for statistically unbiased projections of yields beyond a 30-year maturity. We recently published a white paper detailing our methodology (Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of The Treasury, Office of Economic Policy, White Paper, February 7, 2005) that is available on the Treasury Department web site.

Our budget proposal to reform the calculation of lump-sum benefits also uses the yield curve for calculating the minimum lump sums. We propose to replace the 30-year Treasury rates used in determining lump sum settlements under qualified plans. Using the yield curve to compute lumps sums and the funding required for an annuity eliminates any distortions that would bias the participant's payout decision. Under our proposal, lump sum settlements would be calculated using the same interest rates that are used in discounting pension liabilities: interest rates that are drawn from a zero-coupon corporate bond yield curve based on the interest rates for high quality corporate bonds. This reform includes a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law. The new basis would not apply to distributions in 2005 and 2006 and would be phased in for distributions in 2007 and 2008, with full implementation beginning only in 2009.1[1]

Funding Targets

Under the Administration's proposal, the appropriately measured accrued liability serves as a plan's funding target. A plan's target funding level for minimum required contributions will depend on the financial health of the plan sponsor. Plans sponsored by financially healthy firms (investment grade rated) will have a funding target of 100 percent of ongoing liability. Less healthy plan sponsors (below investment grade rated) will have a funding target of 100 percent of at-risk liability.

A sponsor is considered financially weak if the plan sponsor OR any significant member of the sponsor's controlled group has NO senior unsecured debt that is classified as investment grade by at least one of the nationally recognized rating agencies.

Because at risk funding targets are likely to be significantly higher than ongoing targets, we provide a five year phase in period to the higher target for any plan whose sponsor becomes financially weak. The funding target during the phase-in period will be a weighted average of the ongoing and at-risk targets. 2[2]

Accrued Benefits Funded

Under the proposal, sponsors that fall below minimum funding levels would be required to fund up towards their appropriate target in a timely manner. If the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year would be equal to the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments would be required in amounts that amortize the funding shortfall over a 7-year period. The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in 7 annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of future amortization payments is less than the funding target, that shortfall is amortized over the following 7

1[1] This is a different yield curve phase-in schedule than proposed for the use of the yield curve in discounting pension liabilities for minimum funding purposes.

2[2] The proposal includes a detailed description of the transition rules that govern the phase-in of the higher funding target when a plan changes status from ongoing to at-risk. See the Treasury Blue Book for more information at http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf.

years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.[3][3]

Benefit Limitations

The reform proposal will include benefit limitations for seriously and severely underfunded plans. Benefit restrictions serve three critical purposes. First, they will limit liability growth as a plan becomes progressively underfunded relative to its funding target. It is important to arrest the growth of unfunded liabilities in order to ensure that plan participants will collect benefits that they accrue. Under current law, sponsors of all but the most severely underfunded plans can allow additional benefits to accrue and in many situations, even make benefit improvements. Plan sponsors in financial trouble have an incentive to provide generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likely losses faced by participants and large claims to the PBGC. The second purpose of benefit restrictions is to guard against this type of moral hazard. Third, but certainly not least importantly, I believe benefit restrictions will serve as a very powerful incentive for plan sponsors to maintain well funded plans.

Plans with financially weak sponsors that are funded at a level of between 60 and 80 percent of their targets will be prohibited from offering lump sums or increasing benefits. If funding falls below 60 percent of target liabilities accruals will also stop and there will be no preferential funding of executive compensation. Plans with healthy sponsors will be prohibited from increasing benefits or providing lump sum payments if they are funded at less than 60 percent of their target. Underfunded plans with sponsors in bankruptcy will also be subject to benefit limits.

Increased Deductibility

The Administration proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. The Administration plan matches these new funding responsibilities with new opportunities – an enhanced ability to pre-fund obligations on a tax-preferred basis. Under the Administration's proposal, plans will be able to build two separate funding cushions. The first is equal to 30 percent of ongoing liability and the second allows for prefunding of some expected salary increases for final pay plans, and expected future plan amendments, based on the amendment experience of the last six years, for flat dollar plans. In addition, plans will always be able to deduct contributions that bring a plan's funding level up to at-risk liability.

3[3] This description draws on the description in the Treasury Blue

Higher limits for deductible contributions, along with existing authority to allocate plan assets and hedge investment and interest rate risk, will provide sponsors with the tools they need to smooth contributions over time. We believe that providing sponsors these tools will not only allow for more effective contribution smoothing than is accomplished using the mechanisms embodied in current law, but it will also allow sponsors to optimally balance contribution smoothing with other investment objectives.

Disclosure

The financial health of defined benefit plans must be transparent and fully disclosed to the participants and their families who rely on the promised benefits. While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

The President's proposal would change the disclosures required on the annual report filed with the government, Form 5500 and the Summary Annual Report provided to participants (SAR). On the Form 5500, plans would be required to disclose the plan's ongoing liability and at-risk liability whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

Information provided in the SAR to workers and retirees would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the value of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan year, or February 15 for a calendar year plan. If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Another important aspect of the proposal is allowing broader access to data submitted to PBGC. Under our proposal, the Section 4010 information filed with the PBGC would be made public, except for the information subject to Freedom of Information Act protections for corporate financial information, which includes confidential "trade secrets and commercial or financial information."

PBGC Premiums

The pension insurance premium structure also is in need of reform. Our plan increases incentives for plan funding and provides the pension insurance system with adequate revenues to eventually restore it to financial health. The flat rate premium will be immediately increased from $19 to $30 per participant to reflect wage growth since 1991 when the $19 rate was set. In the future, the flat premium rate will be updated annually using the same index that is used to update PBGC's maximum guarantee limits. This provision will allow the price and level of insurance coverage to grow at the same rate in the future.

The proposal will also introduce a more robust system of risk-based premiums. Risk based premiums will be charges levied on unfunded target liabilities for all plans. Two key differences distinguish risk-based premiums under the proposal from the variable rate premiums of current law. First, the liability on which underfunding is measured for premium purposes is the same liability measure used for the plan's funding target. Second, all plans with unfunded liabilities will pay risk-based premiums. This feature of risk-based premiums should provide a much stronger incentive to maintain adequately funded plans.

Credit Balances

I'd like to say a few words about credit balances. Credit balances are created when a plan makes a contribution that is greater than the required minimum. Under current law, the credit balance, plus an assumed rate of return, can be drawn down to satisfy future minimum contribution requirements. Credit balances that allow underfunded plans are undesirable and dangerous because they create funding holidays as plans become increasingly underfunded and prolong the amount of time that such plans can remain below their funding targets, leaving participants at greater risk. One need only consider the case of Bethlehem Steel to see how significant an issue this is. Just marking credit balances to market is not sufficient to solve the problem if underfunded plans are still able to take funding holidays.

It is critical to note that while our proposal does away with "credit balances" as currently construed, it does not reduce the incentives for plan sponsors to contribute above the minimum. In the Administration's proposal, the focus of the reformed funding rules on assets and accrued liabilities means that pre-funding pays off in a reduction in future required minimum payments. Plans that have made higher than minimum contributions in past years do not lose the value of such contributions. These contributions increase the value of plans assets relative to liabilities and, other things equal, reduce plan underfunding and decreases future amortization payments. In combination with the rest of the proposal, there is more than adequate incentive for plan sponsors to fund above the minimum. In fact here are four other reasons that employers might choose to contribute more than the minimum: (1) The increased deductibility provisions allow sponsors to accumulate on a pre-tax basis; (2) Disclosure of funded status to workers will encourage better funding; (3) A better funded status results in lower PBGC premiums, and (4) A better funded status make benefit restrictions less likely.

Saving and Macroeconomic Effects

National Saving

As I have described, one important goal of the Administration's proposal is to ensure that plans have sufficient funds on hand to meet accurately and meaningfully measured accrued obligations to participants.

The current rules often fail to ensure adequate plan funding – recent history has made this obvious. Formally we might say that the current set of rules has created a partially *pay-as-you* go private pension system by allowing some accrued liabilities to be unfunded. That is, in general, because when plans are not fully funded, the system basically operates by transferring contributions associated with younger workers to the current retired workers.

The funding rules proposed by the Administration, whereby sponsors that fall below the accurately measured minimum funding levels are required to fund up towards their target in a timely manner, move the system in the direction of being *fully-funded*. In a fully-funded system the contributions associated with each generation of workers are invested and fund their own retirements. A basic result in macroeconomics is that a pay-as-you-go system results in less saving, a slower rate of capital accumulation, and a lower steady state capital stock. Therefore the Administration's proposal – through the move towards more fully funded private defined benefit pensions – is consistent with the Administration goal of increasing saving and greater capital accumulation.

Macroeconomic Effects

Recently some analysts have expressed concern that the Administration pension funding proposal could have negative macroeconomic effects. They suggest these effects will come through depressed business investment by underfunded plan sponsors, some of whom will face higher contributions under the Administration's proposal.

I understand that these concerns may be widely held – and are likely to be repeated by the proposals detractors. In fact, in my opinion, sound economic analysis strongly suggests that there are no short- or long-term macroeconomic risks associated with reforming pension funding rules. Quite the contrary, the proposal's long-term economic effects will be positive.

Well-functioning capital markets allow companies to finance attractive investments even if they face short-term demands on their current cash flows. For that reason, many economists believe that there is little link between a company's cash flows – including its pension funding requirements – and its investment decisions. This suggests that as a general matter, pension contributions are unlikely to cause a reduction in the plan sponsor's investment pattern.

There is a strand of economic literature that suggests there is a link between short-term cash flow demands and investment decisions. However, I believe that some of the analysts who have referenced this literature in analyzing a highly stylized and in many respects inaccurate version of the Administration's proposal have misused the literature's results and overstated the effects – if any – of the proposal on plan sponsor investment behavior.

More importantly, it is critical to recognize that pension contributions finance investment throughout the economy. The monies directed into pension accounts are invested in stocks and bonds, thereby deploying these resources throughout the economy. I believe some analysts who have expressed concern about the macroeconomic effects of the Administration's proposal are mistakenly considering only investment by affected plan sponsors, and thus fail capture this additional investment. This may lead them to mistakenly attribute negative macroeconomic effects to the Administration's proposal.

As I have described, I believe there will be no negative short-term macroeconomic effects of the Administration's pension proposal. If there were effects, I am confident that these *de minimus* short-term effects of the proposal would be outweighed by its long-term beneficial effects of increasing saving and capital accumulation.

Conclusion

Defined benefit plans are a vital source of retirement income for millions of Americans. The Administration is committed to ensuring that these plans remain a viable retirement option for those firms that wish to offer them to their employees. The long run viability of the system, however, depends on ensuring that it is financially sound. The Administration's proposal is designed to put the system on secure financial footing in order to safeguard the benefits that plan participants have earned and will earn in the future. We are committed to working with Congress to ensure that effective defined benefit pension reforms that protect worker's pensions are enacted into law.

It has been my pleasure to provide this discussion of the proposal. I look forward to discussing the proposal and the motivations for the proposal further and answering any additional questions you may have.