S. HRG. 109–125

FINANCIAL STATUS OF THE PENSION BENEFIT GUARANTY CORPORATION AND THE ADMINISTRATION'S DEFINED BENEFIT PLAN FUNDING PROPOSAL

HEARING

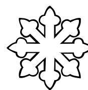
BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MARCH 1, 2005



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FINANCIAL STATUS OF THE PENSION BENEFIT GUARANTY CORPORATION AND THE ADMINISTRATION'S DEFINED BENEFIT PLAN FUNDING PROPOSAL

TUESDAY, MARCH 1, 2005

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:20 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Lott, Snowe, Crapo, Baucus, Rockefeller, Bingaman, and Wyden.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A. U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Today, our committee is going to hear testimony on the state of the defined benefit pension plans. We will focus on the government backer of that system, the Pension Benefit Guaranty Corporation, PBGC, for short. The administration's recent proposal that they put before us to strengthen the pension funding system will also be considered.

Defined benefit plans are, of course, a critical part of our Nation's pension system and they are very important to the economy as a whole. These plans provide retirement income to millions of Americans. Millions of current workers count on these benefits as they look forward to retirement.

Today, our defined benefit pension system is clouded with uncertainty. There is uncertainty for plan sponsors regarding the interest rate used to calculate our pension liabilities, and there is uncertainty for participants who read headlines and actually wonder if their pension benefits will really be there when they retire.

In the last Congress, attention began to focus on replacing the 30-year Treasury rate for pension funding purposes with a new rate. At the same time, questions began to be raised about whether we needed to take a more comprehensive look at reforming the pension funding rules.

Here in the Finance Committee, we worked in a bipartisan way, which is the tradition of this committee, on a comprehensive bill that has the acronym NESTEG. NESTEG included permanent replacement for the 30-year Treasury rate, with yield curves, along with the first round of proposals from the administration, to strengthen pension funding.

In acting on NESTEG, I, along with Senator Baucus, also asked the administration to provide details on more comprehensive pension funding reforms on which they were working. We now have those details, and we will spend a considerable amount of time today discussing and debating them in this hearing. So, I look forward to a spirited and thought-provoking discussion.

I believe it is very critically important that we enact a permanent set of pension funding rules this year, with emphasis upon permanent. It is critically important to our economy, it is critically important to the companies that sponsor plans, and most of all it is critically important for the workers who depend on these plans for retirement.

To that end, I and Senator Baucus have reintroduced last year's committee-reported NESTEG bill and announced our intentions to work to reform the pension funding rules in a permanent manner.

Defined benefit plans are a vital part of our private retirement system. At the same time that we recognize the defined benefit pension system's many good attributes, it seems we must also be mindful of its current problems.

The PBGC's current deficit is $23 billion. That is $23 billion of exposure for all taxpayers. Most of those taxpayers do not have a stake in the defined benefit system. Only about 20 percent of the workers have a defined benefit plan, so about half of workers lack an employer-provided retirement plan, either defined benefit or defined contribution.

So, they just do not have any of those benefits, and it seems to me a very sad and disturbing statement in and of itself. Hopefully we can move that percentage up quite a bit.

To the extent that progress has been made on increasing retirement plan coverage, this committee, I think, has been largely responsible. I worked to have retirement savings provisions included in the 2001 tax bill, and I have enjoyed a long relationship working with Senator Baucus on increasing coverage and improving our retirement system. One such idea is the bipartisan saver's credit that Senator Baucus pursued with others in the 2001 Tax Act.

Since only about 20 percent of the workers participate in a defined benefit plan, one question we have to confront is whether the other 80 percent of the workers not covered by defined benefit plans should be responsible for subsidizing the pension benefits of the minority percentage that does have it.

There are other alarming trends to note as well. Many employers, particularly those in older industries, have over-promised and under-funded, and sometimes both situations have existed of over-promising and under-funding. Those promises eventually become due, and are coming due.

Too often, these businesses, with the collaboration of unions, act as if their obligation to their workers are somehow not their responsibility, but the taxpayers' responsibility.

Far too often, large companies have cavalierly sloughed off their defined benefit liability onto the taxpayer. Far, far too often, the taxpayers have ended up holding the bag on a badly negotiated employee benefit deal.

The administration, to its credit, has stepped up with a tough defined benefit reform package that would strengthen pension fund-

ing. The predictable howling from some employers and union groups has already begun. I say to all those who are howlers something like Ross Perot would say: “I’m all ears.” I want to hear. But what we do not want to hear, is complaints only.

Now, you can legitimately not like the administration’s tough medicine, but, also, what is your solution? How do you assure the taxpayers that we are not digging a bigger deficit ditch at the PBGC? How do you assure current retirees that they can count on funding sources for the benefits that were promised to them?

How do you assure workers that their promised defined benefits will not be defined and paid for, not by your agreement, but by the Federal Government, which is probably going to be a lot less? So, I am looking for answers here. I am not looking for complaints without constructive alternatives.

And while we are talking about constructive alternatives, I would like to ask everybody who is in Congress to consider turning off any anti-Social Security reform water cannons, for today, at least. Let us put away the charts, shut down the biased benefit calculators, focus on solving the problem and doing the people’s business.

Instead of strident statements against any effort to reform Social Security, I would like us to recognize that President Bush has raised the profile of a Nation’s retirement security challenge.

If you laid out 10 charts in front of us, there would not be a Republican or Democrat who would disagree with the figures of what the short funding and the liability is. It is also kind of a mathematical equation of what you put together to solve that problem.

So I think the President has used the bully pulpit to put retirement security issues front and center, and I do not think we should waste the opportunity.

I am still hopeful that the Finance Committee can rise above the discussions that really have not taken place yet between Senators, but over the airwaves, and see what we can do about Social Security, because it is part of the three-legged stool of retirement that Franklin Roosevelt talked about: pensions, personal savings, and Social Security.

Of course, with what we are dealing with here today, fixing the defined benefit system can be a part of that effort. I am not one of those opposed to expanding the whole issue of Social Security beyond just Social Security to solving some of our retirement problems and encouraging more savings. We owe it to the people that sent us here to focus on these problems. Most of us got on this committee to solve problems, and we are going to do that.*

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I first want to congratulate you on that colorful, metaphor-rich statement. Second, I would say that I think all members of the Senate appreciate the President bringing to the fore some of the challenges facing Social Security.

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*For more information, *see also,* “Present Law and Background Relating to Employer-Sponsored Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation (PBGC),” Joint Committee on Taxation staff report, February 28, 2005 (JCX–03–05).

Now, we all know it is not a crisis, but it is a long-term challenge. Medicare is much more of a crisis facing this country. That trust fund is due to go belly-up very soon. Much more dire straits face us because of the Medicare trust fund compared to Social Security.

Nevertheless, I appreciate the President raising the issue. I also appreciate, frankly, the good judgment of the American people, our employers, who have so far been fairly critical, quite critical, of the President's private accounts.

We all know that private accounts do nothing to solve the long-term solvency of Social Security, and actually increase the solvency problems facing Social Security. So, as we work to try to find a solution, Mr. Chairman, I very much agree with you that we have to look at all options. It is pension reform, it is personal savings, but it is also not undermining Social Security, but strengthening Social Security.

Mr. Chairman, I also might add that this hearing is quite important because we have to find good, long-term ways to strengthen and fund a benefit pension system. It is one of the major cornerstones of retirement. I might remind us that the defined benefit system provides retirement security for over 40 million Americans. A lot of people depend upon defined benefit plans.

Of course, we are here to examine the financial status of the Pension Benefit Guaranty Corporation, otherwise known as the PBGC, and also the funding rules, that is, the amount companies are required to contribute to their pension plans that underpin the benefit promises to these millions of workers.

PBGC is feeling increasing financial pressure. I might remind us, at the end of 2004, PBGC had a deficit of $23.3 billion. That is a $12 billion loss, in addition to—that is, over—the preceding year.

PBGC has estimated that single-employer plans covered by its insurance program are under-funded by a collective $450 billion. That is a big increase from last year, when it was about $350 billion of under-funding. So, the trend is very much in the wrong direction.

These under-funded liabilities also come at a time when the number of single-employer defined benefit plans covered by the PBGC has declined precipitously, from a high of 112,000 plans in 1985, to fewer than 30,000 plans today.

As we examine pension funding, we must keep in mind that benefit guarantees and minimum funding rules must go hand in hand. It is appropriate that we are addressing both of those here today.

In 1974, Congress passed something called ERISA. Not many Americans know what ERISA stands for, but what ERISA basically does is set some rules and guidelines. Someone once said, the only person ever to really have understood ERISA and all the pension law and all of its ramifications was the late Senator Jack Javitz, one of the sponsors of ERISA back in 1974.

He was a great American. All of us who knew him had the highest regard for him. But Jake Javitz—Jack, to some of his closer friends—was a great American who tried to help set us on the right path to setting some guidelines for defined benefit plans.

Back then in 1974, PBGC was created, and also the minimum funding rules for defined benefit plans were created. Before that

year, however, there were no guaranteed benefits. That is, if a pension plan terminated with insufficient assets, the participants—that is, the employees and retirees—could lose everything.

When Congress established PBGC to provide participants—that is, employees and retirees—with some level of benefit guarantee, Congress also established minimum funding rules to make companies fund benefit promises in an orderly fashion.

Now, funding rules have always been challenging. Setting the rules follows a difficult balance. If contribution requirements by companies are set too low, workers risk losing promised benefits.

But if contributions are set too high, cash that could be used for business expansion is tied up in the pension plan and companies may not, therefore, offer the plans because of the cost.

To require this money to be contributed when a company is already struggling financially, you risk pushing that company over the cliff into bankruptcy. So, there are no easy answers here. It is a question of where you draw the line and the fairest place to draw that line.

I want to thank the administration for its efforts. It has attempted to come up with a proposal. It has its own funding proposal, and I recognize the tremendous amount of effort that went into it. It deserves very thoughtful consideration.

Some of our witnesses today, however, believe that the proposal will hurt, not help, the defined benefit system. We will hear the kinds of concerns that make defined benefit funding rules such a challenge.

Some of their concerns are these. First, plan sponsors, they say, need predictability of contribution requirements for cash flow planning, but the proposal before us may actually increase the volatility of minimum funding requirements, clearly a point we have to look at because we do not want a lot of volatility. On the other hand, we want to make sure that these plans are adequately and properly funded.

Other concerns are that the proposal does not go far enough to encourage employers to make contributions in excess of minimum requirements, and linking a plan's funding target to a company's financial health, the concern is, would result in a downward spiral for troubled employers.

Clearly, we look forward to hearing from the witnesses. We very much appreciate their expertise. It was just last spring that we passed the Pension Funding Equity Act, and that provided a 2-year temporary substitute of the interest rate on long-term corporate bonds for the 30-year Treasury rate. That temporary substitute, we all know, expires at the end of this year.

I hope that we can enact a long-term solution this year. There have been too many times in this Congress, and particularly in the last several years, where we just passed extensions: 6 months, 9 months, a year. We are falling into the trap here of too many extensions and not biting the bullet and settling down to try to pass legislation that is more permanent.

Now, nothing is permanent, clearly, but the 2- and 3-year extensions, frankly, I think are a bad direction to be going in. Rather, we need a little more certainty, a little more predictability to help

our companies, to help our employees, and frankly, help the country.

I hope we can enact that. I hope we can finally enact some kind of a long-term solution here that includes not only the interest rate replacement, but other reforms that are critical to the defined benefit system.

I look forward to our witnesses. Mr. Chairman, I thank you very much for holding this hearing.

The CHAIRMAN. Yes. And thank you for your statement. I appreciate it very much.

We have at the table Mark Warshawsky, Assistant Secretary of Treasury for Economic Policy; and Ann Combs, Assistant Secretary of Labor for the Employee Benefits Security Administration. They have lead roles at their Departments in developing the administration's pension funding reform proposal. And we have Brad Belt, who is the Executive Director of the PBGC.

So, unless you folks have worked out something different, I would start with you, Mr. Warshawsky.

Mr. WARSHAWSKY. Actually, I think Brad will lead off.

The CHAIRMAN. Brad, you go ahead.

STATEMENT OF HON. BRADLEY D. BELT, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. BELT. Thank you, Mr. Chairman, Ranking Member Baucus, and members of the committee. I commend you for your leadership on retirement security issues, and I appreciate the opportunity to discuss the need for comprehensive pension reform this afternoon.

My written testimony describes in detail the financial status of the pension insurance program and the flaws in the current funding rules that have led us to this point.

I would like to mention just a few key points that highlight the need for the administration's reform proposals which my colleagues will discuss momentarily.

The first point is that we have already dug a fairly deep hole and it could get much deeper if we do nothing. PBGC's accumulated deficit, as the Chairman and Ranking Member noted, was just over $23 billion at the end of this past fiscal year. That is a $30 billion swing in just 3 years.

The most recent snapshot taken by the PBGC finds that corporate America's pension promises are under-funded by more than $450 billion. More important, almost $100 billion of this underfunding resides in pension plans at greater risk of termination because the sponsoring company faces financial difficulties.

I would note, Mr. Chairman, that the risks of further significant losses are not limited to the steel and airline industries, as some have asserted. Yes, the most immediate threat comes from the airline industry.

The PBGC recently absorbed the under-funded pensions of U.S. Airways at a cost of $3 billion, and United Airlines wants to saddle the insurance program with a claim of more than $6 billion.

Other airline executives have publicly stated that they would feel competitive pressure to follow suit if United successfully transfers its pension costs to the insurance program.

But the problem extends beyond airlines. As I noted, we estimate that non-investment-grade companies sponsored pension plans with a total funding shortfall of $96 billion. This exposure spans a range of industries, from manufacturing, transportation and communications, to utilities, wholesale, and retail trade.

It would also be a mistake, in my view, to assume that these are merely cyclical problems and that a return to the bull markets of the 1990s will save the day. We cannot predict the future path of either equity values or interest rates.

While equity markets have performed reasonably well in recent months, long-term interest rates have stayed near historic lows. More important, rising markets would not address the underlying structural flaws in the pension system.

That leads to my second point, that the status quo rules have led to this hearing. Simply put, the funding rules are needlessly complex and fail to ensure that pension plans are adequately funded.

Rather than encouraging strong funding and dampening volatility, the use of smoothing mechanisms and credit balances have been primary contributors to systemic under-funding.

The sad fact is that companies can comply with all of the requirements of ERISA and the Internal Revenue Code and still end up with plans that are much less than 50-percent funded when terminated.

The system is also rife with what economists call moral hazard. A properly designed insurance system has mechanisms for encouraging responsible behavior and discouraging risky behavior. Unfortunately, the incentives in the pension insurance program run the other way.

In addition, the system suffers from a disturbing lack of transparency. The current disclosure rules obfuscate economic reality, shielding relevant information about the funded status of pension plans from participants, investors, and even regulators.

The third, and most important point, Mr. Chairman, is that this is not about the Pension Benefit Guaranty Corporation, it is about the retirement security of tens of millions of American workers. The fact is, the termination of under-funded pension plans can have harsh consequences for workers and retirees.

The administration is committed to defined benefit plans, which are an important source of secure retirement income. But when plans terminate, workers' and retirees' expectations of a secure future may be shattered because, by law, not all benefits promised under a plan are guaranteed.

Other companies that sponsor defined benefit plans also pay a price through higher premiums when under-funded plans terminate. Not only will healthy companies be subsidizing weak companies with chronically under-funded pension plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor cost onto the government.

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would cause responsible premium payers to exit the system. If this were to occur, Congress would face pressure to have U.S. taxpayers pay the benefits of workers whose pension plans failed.

Mr. Chairman, the issues surrounding defined benefit plans ultimately boil down to one question: who will pay for the pension promises that companies make their workers?

There are only four choices: the company that made the pension promise, other companies through higher premiums, participants through lower benefits, or taxpayers through a rescue of the insurance fund.

The administration believes that companies that make pension promises should pay for their pension promises and not shift the costs to others.

Thank you for inviting me to testify. Of course, I would be pleased to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Belt.

[The prepared statement of Mr. Belt appears in the appendix.]

The CHAIRMAN. Mr. Warshawsky?

STATEMENT OF HON. MARK J. WARSHAWSKY, ASSISTANT SECRETARY FOR ECONOMIC POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. WARSHAWSKY. Thank you, Mr. Chairman.

Good afternoon, Chairman Grassley, Ranking Member Baucus, 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. In my testimony, I will focus on the proposal's funding rules, in particular, the calculation of the funding targets.

As my colleague, Brad Belt, described to the committee, the single-employer pension system is in serious financial trouble. Many plans are badly under-funded, jeopardizing the pensions of millions of Americans workers, and the insurance system which protects those workers in the event that their own pension plans fail has a substantial deficit.

The goal of the administration's proposal 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.

I believe that the current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. The cause of financial problems is the regulatory structure of the defined benefit system itself. Minor tinkering with the existing rules will not solve these problems.

If you want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system to make it financially sound. The current rules are needlessly complex, while failing to ensure that many pension plans remain prudently funded.

The administration's proposal addresses these problems and improves the funding rules. I will discuss the funding rules, while my colleague, Ann Combs, will discuss the other elements of the proposal.

Accurate measurement is the predicate step in ensuring that plans remain well-funded and workers' and retirees' benefits are made secure. The system of smoothing embodied in current law serves only to mask the true financial condition of pension plans

and to shift the risk of unfunded liabilities from firms that sponsor under-funded plans to plan participants and other plan sponsors in the pension insurance system.

Under our proposal, assets will be marked to market, and liabilities will be measured using a current spot yield curve that takes account of the timing of future benefit payments summed across all plan participants.

Discounting future benefit cash flows using the rates from a 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 prudent and a common practice. Yield curves are regularly used in valuing other financial instruments and obligations, including mortgages, certificates of deposit, and others.

The administration recognizes that the current funding rules, particularly the deficit reduction contribution mechanism and the limits on tax deductibility of contributions, have contributed to funding volatility. This is a current problem.

Our proposal is designed to remedy these issues. We feel that increasing the contribution limit will give plan sponsors additional ability to fund during good times.

Increasing the amortization period to 7 years compared to a period as short as 4 years under current law, together with the existing freedom that plans have to choose pension fund investments, will enable plans to smooth contributions over the business cycle.

Plan sponsors may choose to limit volatility by choosing an asset allocation strategy or conservative funding level so that financial market changes will not result in large increases in minimum contributions.

These are appropriate methods for dealing with risk. It is inappropriate to limit contribution volatility by transferring the risk to plan participants and the PBGC.

Under our proposal, planned funding targets for healthy plan sponsors will be established at a level that reflects the full value of benefits earned today under the assumption that plan participant behavior remains largely consistent with past history of an ongoing concern. Plans sponsored by firms with below-investment-grade credit will be required to fund to a higher standard that reflects the increased risk that these plans will terminate, and hence that the take-up of early retirement benefits and lump sums will be accelerated.

Pension plans sponsored by firms with poor credit ratings pose the greatest risk of such defaults. It is only natural that pension plans with sponsors that fall into this readily observable high-risk category should have more stringent funding standards.

Credit ratings are used throughout the economy, and in many government regulations to measure the risk that a firm will default on its obligations. A prudent system of pension regulation and insurance would be lacking if it did not use this information.

Credit balances are created when a plan makes contributions that are greater than the required minimum. Under current law,

a credit balance, plus an assumed rate of return, can be used to offset future contributions.

We see two very significant problems with this system. First, the assets that underlie credit balances may lose, rather than gain, value. Second, and far more important, credit balances allow plans that are seriously under-funded to take funding holidays. In our view, every under-funded plan should make minimum annual contributions. Under our proposal, contributions in excess of the minimum will reduce future minimum contributions. These contributions are added to plan assets and, all other things being equal, reduce the amount of time that the sponsor must make minimum contributions to the plan. We believe this is the correct approach.

In conclusion, we are committed to ensuring that defined benefit 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.

Our proposal is designed to do exactly that, 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 the effective reforms that protect workers' pensions are enacted into law.

It has been my pleasure to discuss this proposal, and my colleagues and I look forward to answering any questions.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Warshawsky appears in the appendix.]

The CHAIRMAN. Now, Secretary Combs?

STATEMENT OF HON. ANN COMBS, ASSISTANT SECRETARY FOR THE EMPLOYEE BENEFITS SECURITY ADMINISTRATION, DEPARTMENT OF LABOR, WASHINGTON, DC

Ms. COMBS. Thank you. Good afternoon, Chairman Grassley, Ranking Member Baucus, and members of the committee. Thank you for inviting us today to discuss the administration's proposal to strengthen the defined benefit pension plans.

The defined benefit system needs comprehensive reform. Mere tinkering with the current rules will not fix its problems. The administration's reform package will improve pension security for workers and retirees, stabilize the defined benefit system, and avoid the need for a taxpayer bail-out of the PBGC.

I am going to focus on three key elements of the proposal. First, preventing hollow benefit promises by severely under-funded pension plans. Second, improving disclosure to workers, investors and regulators. Third, reforming the PBGC premium system to better reflect the real risks and the costs of the guaranty program.

Under the current funding rules, financially weak companies can promise new benefits and make lump-sum payments that the plan cannot afford. Workers, retirees, and their families who rely on these empty promises can face serious financial hardship if the pension plan is terminated. The administration's proposal prevents this by ensuring companies make promises they can afford and keep the promises they make.

First, the proposal would allow a plan to increase benefits only if the plan is more than 80-percent funded or if the new benefits are fully and immediately funded.

Second, a plan could not make lump-sum payments unless it is more than 60-percent funded, or if the plan sponsor is financially weak, more than 80-percent funded. This will ensure that workers are treated fairly, preventing a run on the bank, where a few collect at the expense of those left behind in the plan.

Third, plans sponsored by financially weak companies that are less than 60-percent funded would have no new benefit accruals until their funded status improved. A plan sponsored by a bankrupt company would be frozen until the plan is fully funded.

Our proposal also prevents corporate executives from securing their own retirements while workers' plans are at risk, an abuse recently seen in the airline industry.

Under our proposal, financially weak companies with severely under-funded plans could not fund non-qualified deferred executive compensation arrangements. Any money used for that purpose would be considered assets of the pension plan and could be recovered by the plan.

Plans that become subject to any of these benefit limitations would be required to notify affected workers, making them aware that the deteriorating funding is threatening their benefits.

Our intent in proposing these new benefit restrictions for severely under-funded plans is two-fold. We want to create a strong incentive for employers to adequately fund their plans, and we want to be sure that the promises already made to workers are honored before additional hollow promises are made, raising false expectations that cannot be met.

The financial health of defined benefit plans must be transparent and fully disclosed to workers and retirees, as well as to regulators and investors. The administration's proposal would accelerate and improve annual disclosures to covered workers and retirees.

Each plan would disclose its funded status relative to its own funding target for the current year and for the 2 preceding years, along with information about the company's financial health and the PBGC guarantees.

These disclosures will ensure that workers have the information they need to talk to their employers about the funding of their plans and to make informed choices about their retirements.

It will correct the current situation where so many workers and retirees have lost benefits with little or no advance warning, having been told that their plans were adequately funded.

Another key reform is to improve the timeliness and the accuracy of annual plan reports to the government. Under current law, the information reported does not accurately measure liabilities and assets and can be nearly 2 years out of date.

Under the administration's proposal, each plan would report annually the market value of its assets and the value of its liabilities, as measured on both an ongoing and an at-risk liability basis. The proposal would also shorten the deadline for large, under-funded plans to report their actuarial information.

In addition, under current law, certain under-funded plan sponsors must provide plan funding and related information to the

PBGC. Our proposal would allow such information to be disclosed to the public, while protecting sensitive information such as trade secrets.

Finally, our proposal will help restore the financial integrity of the Federal insurance system by improving the PBGC premium structure. It would immediately adjust the flat-rate per-participant annual premium to $30 to reflect the growth in worker wages since 1991, when the current $19 figure was set. Going forward, the flat-rate premium would be indexed for wage growth, similar to the manner in which the PBGC guarantee limit is indexed.

All companies with under-funded plans would pay an additional risk-based premium based on the plan's funding shortfall. The PBGC board would adjust the risk-based premium periodically so that premium revenue is sufficient to meet expected claims and pay off the current deficit over time.

The new risk-based premium will be far more reflective of actual risk than the current-law variable-rate premium. Unlike the latter, it will be based on an accurate funding target that takes account of the plan sponsor's financial condition.

To keep premiums to a reasonable level, we must relieve the insurance program of certain unreasonable risks. The administration's proposal would freeze the PBGC guarantee limit when a company enters bankruptcy and help the PBGC collect missed required pension contributions while the firm is in bankruptcy.

The proposal also would prospectively eliminate the guarantee of shut-down benefits and prohibit such unfunded benefits in pension plans. Shut-down benefits cannot be pre-funded because they are, by definition, unpredictable events. They are more like severance plans, and we believe they should be treated as such.

The Bush administration, in conclusion, is committed to working with Congress to ensure that meaningful defined benefit pension reforms like those included in the President's budget are enacted into law.

We look forward to working with the members of this committee to achieve greater retirement security for the millions of American workers, retirees, and their families who depend on defined benefit plans.

Thank you very much. I, too, would be happy to take questions.

[The prepared statement of Ms. Combs appears in the appendix.]

The CHAIRMAN. I thank the entire panel. We will have 5-minute turns.

My first question is directed towards anybody on the panel who would want to answer. I think all three of you can answer it, but maybe if it is the same answer, just have one answer.

It is my understanding that United Airlines' pension plans might be $8 billion under-funded, and if United succeeds in dumping these liabilities, that the PBGC will have to absorb a $6 billion hit. But I have also been told that United's pensions have been funded consistently with the rules.

So, I need to have you explain to me what the problems are with the current rules that will allow a situation like this to occur, and, if there are external factors outside the rules, could you comment on other factors at work here?

Mr. BELT. Mr. Chairman, I would be delighted to take first crack at that one. United does present an interesting case example of the problems that exist under the current funding rules. It was really a combination of factors that got them to the point of being $8 billion under-funded.

Going back a little bit in time where they were already substantially under-funded, about the 2000 time frame, at least on a termination liability basis, even though they were reporting to investors and shareholders that they were fully funded, they stopped making contributions into the pension plan because they were taking advantage of credit balances, notwithstanding the fact that asset values were falling and liabilities were continuing to accrue, and liabilities were also going up because interest rates were falling.

Notwithstanding the fact that they were putting no money into the plan and the plan was becoming increasingly under-funded, also during this time they were able to negotiate new benefit increases. As a result, over a period of about 3 or 4 years, the total amount of under-funding grew by $3 or $4 billion, fully consistent with the rules.

As a result, if the plan does terminate—and that is what the company has indicated its intention is—their total under-funding is about $8 billion, and the Pension Insurance program would assume a liability or a claim of more than $6 billion. Again, and they make this point in their court papers, they have fully complied with the ERISA funding rules.

The CHAIRMAN. Some groups seem to believe that the PBGC might be crying wolf. They believe that much of the problem is either cyclical due to the "perfect storm" of low interest rates and low stock market values, or the result of industry-specific problems, steel and airlines as an example. How do you view the causes of the current situation? Will cyclical changes over time remedy the problem in industries other than airlines and steel?

Mr. BELT. As I noted in my testimony, Mr. Chairman, the risks faced by the Pension Insurance program and the significant levels of under-funding, particularly that $100 billion that I mentioned that is in plans sponsored by companies that are not as financially healthy, is in a wide variety of different industry sectors. In fact, a majority of that is outside of airlines and steel. So, there are significant risks beyond just those two industries.

It is distinctly possible that we could see a return to the bull markets of the 1990s. It is distinctly possible that we could have a sudden spike in interest rates that would close this funding gap.

It is also just as possible you could go the other direction. Long-term rates in other countries are much lower than they are in the United States right now. We could certainly see markets fall at some point in time.

So, we've got a significant hole right now. Unfortunately, it's growing bigger rather than filling the hole. I think the most important point to note is that the current system has allowed us to get to this very deep hole and allows the hole to continue to get deeper.

The CHAIRMAN. My next question would be for anybody on the panel. We are going to hear, during the second panel, testimony from business and labor groups criticizing the yield curve as creating too much volatility in pension funding, primarily because of

the use of the near-spot interest rates and the elimination of smoothing mechanisms that exist under current rules.

They also criticize the use of credit ratings for various purposes under the proposals. So I need to have, from one or all of you, a response to those criticisms we are going to hear in the next panel.

Mr. WARSHAWSKY. Mr. Chairman, I will take that question. Number one, we feel it is very important that assets and liabilities are measured accurately. The smoothing which is currently used may, in fact, be masking the true status of the plan.

We also feel that the new tools that we are proposing—the 7-year amortization and the ability to make additional tax-deductible contributions—will enable companies to manage the volatility in an appropriate and prudent way. With regard to credit rating, we also feel that this is a very important reform, basically reflecting the risk that those plans represent.

The CHAIRMAN. All right.

I am very concerned that any pension funding reforms give employers ample ability to advance-fund their plans during good times. In that regard, I am pleased to see that your proposal included a significant increase in the ceiling on employer contributions identical to what this committee has done in the NESTEG bill.

Now, some have argued—and I think some of these folks will be represented on our second panel—that your proposals limit the incentives to advance-funding by eliminating credit balances.

Do you believe that it is necessary to eliminate credit balances altogether rather than reform them to make the proposal work? I want to remind the committee, I started my question before the red light went on. [Laughter.] Go ahead and answer, please.

Mr. WARSHAWSKY. Mr. Chairman, we feel that the generous allowance of additional funding will be very helpful in allowing plans to manage the risks that they undertake.

We also feel that the current system, as Brad Belt has indicated, has really been rife with abuse because the credit balances do not reflect market value of assets, but even more importantly, they allow companies to take very extensive funding holidays, sometimes a matter of years, when the plan is under-funded. That is simply inappropriate.

Mr. BELT. And, Mr. Chairman, if I could add to that, just a specific example, citing back to United. This is from information that United provided in the bankruptcy court proceedings. This is not PBGC's information.

They noted that they used credit balances for their pilots' plan from the period of 2000, running all the way through the end of this year, in which they had put no money into the pilots' plan because of the credit balances that were available to them, notwithstanding the fact that when we take over that plan it is going to be $3 billion under-funded. So, for 5 years they have been able to use credit balances to not put any money in the plan, notwithstanding the fact that liabilities have grown substantially.

The CHAIRMAN. Thank you.

Now I am going to call on Senator Baucus. But it would be this order: Senator Crapo, if he would return; Senator Bingaman, if he

would return; then Senator Wyden, Senator Lott, Senator Rockefeller, and Senator Snowe, in that order.

Senator BAUCUS. Thank you, Mr. Chairman.

I have four questions, and I do not really care who answers them. You can decide among yourselves. But I am going to ask each of the four, and then ask you to answer all of the four.

The first, is the proposal shows that $26 billion is to be raised by premiums over the next 10 years. In view of current premium revenues, about $1.5 billion per year, that calculates to about a 170-percent increase in premiums.

My first question is, how much of that is due to the flat-rate premium and how much to the variable, and what problems might that cause employers?

The second question is, we were here 10 years ago dealing with all this, and we thought we had it all solved and the system was flush for a while. Now, here we are again. So my question is, how can we be assured that we will not be back here 10 years later with these same problems, based upon your suggestions?

The third question is, many negotiated plans have flat-dollar benefit formulas, while most plans for management and other non-union employees have a formula tied to salary, so there is built-in inflation for salaries of employees, but not for wage earners. Under a flat-dollar plan, it takes a plan amendment to adjust benefits for inflation.

I would like for you to explain how your proposal's limitation on benefit increases for plans that are less than 80-percent funded affects those two different types of plans.

Then, finally, I am just curious. The administration thinks that individuals with Social Security should invest in equities. Why is the same not true for retirees and employees where, in this case, professional investment advisors have managed defined benefit plans that would not allow investment in equities, but rather there is a very strong, implicit position that the plan should be invested in a bond portfolio?

So if we do not trust plans with financial advisors to invest in equities and plans, why in the world should we be trusting individuals to invest in equities for their defined benefit portion that is the nature of Social Security? Those are the questions.

Mr. BELT. I guess I would be happy to take the first one, Senator Baucus, on the premium issue.

Under current law, we have historically derived about a billion dollars a year in premium revenues, but that has been trending up a little bit. It was about $1.5 billion this year, and it is estimated in our baseline assumptions to be a little over $2 billion going forward. Of the $26 billion that you have mentioned, that is for budget estimate purposes.

The proposal is actually to increase the flat-rate premium from $19 per capita to $30 per capita, and that would be the first increase since 1994 in the flat-rate premium, which would bring the flat-rate premium revenues to close to $1 billion a year. They have been about $600 million a year to about $1 billion, and that is compared to claims of $16 billion just over the last 3 years.

Senator BAUCUS. Well, just so we get our facts straight, is that a 170-percent increase?

Mr. BELT. No, it is not, not over baseline assumptions. It is about a 50-percent increase in the flat-rate premium. The variable-rate premium, the policy proposes that the PBGC board would set that based upon current facts and circumstances.

So, there is no established variable-rate premium. What is established in the proposal is that the flat-rate premium would increase from $19 to $30.

Senator BAUCUS. All right.

Next question?

Ms. COMBS. We have negotiated here. I think I will take the second one, which was how can we ensure that we are not back here in 10 years.

Senator BAUCUS. Yes. Right. What is there about this proposal that reasonably assures we are not going to be back here again?

Ms. COMBS. Well, I was actually involved 10 years ago as well, so we all have incentives to get it right this time. I think we have added some additional and different elements in this proposal which will give us better assurance that we can solve the problem going forward. I think, importantly, we have introduced for the first time the idea of the financial risk of the plan sponsor.

I think our experience has shown at PBGC that it is not just the funding rules—they are very important because they determine the size of the claim—but it is the financial health of the company sponsoring the plan that determines the incidence of the claim, whether or not the plan will be terminated.

So, I think our proposal to have both the funding targets and the premiums linked to the financial riskiness of the firm is an important change, and one that will help a great deal.

I also think our willingness to take on the issue of benefit limitations, which we recognize is a sensitive issue but one that we think is very important, if you are in a big hole and you have not paid for the promises you have already made, we think the law should restrict your ability to keep making additional promises.

Senator BAUCUS. If I might, just very briefly. I find it hard to think we should give a big extra hit to companies that are stressed. Why stress them more if they are already stressed?

Second, some of the stress is going to be through no fault of their own. A very well-managed company, whether it is a big change in trade law, or who knows what, a flood, or something might happen that puts a company in a very financially stressed position.

Ms. COMBS. Well, our proposal does not create any new exposure for companies. These promises have been made, these liabilities are there. What we are trying to do is have more transparency about what the liabilities actually are and a reasonable period of time for people to meet those obligations, and, again, some real incentives for them not to continue to make promises that they cannot fund.

So we are hoping that companies can get themselves, over a reasonable period of time, into a situation where the true liabilities are recognized and funded and that plans do not get in a situation where they continue to allow these plans—it is the unfunded liability that creates the problems, the financial problems, for these companies now, not the other way around.

Senator BAUCUS. Right.

Ms. COMBS. And their financial situation should not be financed on the pension plan.

Senator BAUCUS. I do not want to take advantage of my colleagues, but if someone could very briefly, just maybe in one sentence, address the other two.

Mr. WARSHAWSKY. Well, let me address your final question on equity investments. The proposal does not direct companies to invest plan assets in bonds.

Senator BAUCUS. That is the implied assumption.

Mr. WARSHAWSKY. Not necessarily. It depends on the company's situation. It depends on the demographics of the plan. It depends on the tolerance of risk of the company. It is really their choice. We are providing tools to manage risk, but we are not directing them to invest in any direction one way or the other.

Mr. BELT. And I would also note that, in contrast to the Social Security situation, the participants' benefits are derived by formula. They do not directly benefit from any increases realized by the pension plan. Those may or may not inure to the benefit of shareholders, but they do not inure directly to the benefit of the participants.

Senator BAUCUS. And, very briefly, the difference between salaried employees and non-salaried employees?

Ms. COMBS. On the benefit limitations, the hourly plans, you are correct. When they negotiate a benefit increase, there is a past service liability that springs up, if you will, and we would have that amortized over the full 7-year period. So, that would be reflected. In salary plans, they are automatically kind of adjusted because it is in the salary function.

Senator BAUCUS. Is that fair?

Ms. COMBS. We think we create more parity between the two. Also, for the first time, we would allow hourly plans to anticipate future salary in the maximum contributions that they can make.

Senator BAUCUS. All right. My time has expired. Thank you.

The CHAIRMAN. Thank you, Senator Baucus.

Now, Senator Bingaman?

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Thank you all for testifying. I understand some of your proposals, and some of them sound meritorious to me. I saw an editorial in *Business Week,* January 31, that caught my eye. "Do Not Pass the Buck on Pensions," was the name of it.

It said, "The PBGC insures the pensions of 35 million Americans, but lately it has been insuring the financial success of turn-around specialists who buy weak companies with big legacy costs, dump their pensions on the PBGC, and flip the assets for hefty profits."

Then it goes on to say, "When the government bailed out Chrysler Corporation 2 decades ago, it demanded an equity kicker for the loans. When it offered loan guarantees to the airlines after September 11, it made equity part of the deal. If the PBGC is to play a central role in making the U.S. economy more efficient, it should demand no less: equity is the answer."

What is your reaction to that? Since we are talking about this law, why do we not provide that if you have to come in and take over these pension obligations of a company, that if that company

re-emerges as a profitable entity, you wind up owning a chunk of it? Would that not help solve your financial problems?

Mr. BELT. Senator Bingaman, actually, under current law, in some cases, our recovery will turn out to be equity. There may not always be cash available in the company once it emerges to be able to satisfy the claims owed to the Pension Insurance Fund. It is distinctly possible, for example, in the United Airlines case, that our recovery could be in the form of equity. We could become a substantial holder in United Airlines.

The situation you were alluding to is a different one. It is not when the company re-emerges or re-organizes under bankruptcy, but actually liquidates their assets and you find somebody coming along and picking up the leftovers and then pumping new money in, and now that the pension liabilities have been shed, being able to make a go of the business.

That is a function of the current law that does not address asset sales or liquidations. But in the case of reorganization, in some cases the PBGC will end up with equity.

Senator BINGAMAN. But do you agree with the thrust of the editorial, that we ought to change the law so that when the pension obligations are shed, PBGC winds up with equity?

Mr. BELT. Our focus in the administration has been on making sure that pension plans are well-funded. Hopefully, they do not terminate at all, and then if they do terminate, they are fully funded so these are not issues. So, that is where we want to really put the attention.

At the margins, there are other situations that may arise. For example, part of the administration's proposal is to strengthen PBGC's claim in bankruptcy in a limited context, but even there, there are trade-offs.

Our focus has really been making sure that hopefully pension plans do not terminate in the first place, and when they do, there are assets there to satisfy the liability so this does not even become an issue.

Senator BINGAMAN. Well, but your focus is also to try to ensure the long-term solvency of PBGC. This is a suggestion they are making for how that could be accomplished, but you have no position on whether this makes sense as a partial way to ensure PBGC's long-term solvency?

Mr. BELT. I have got to be honest, Senator, I have not thought through fully the ramifications on the asset sale side. As I indicated already, in reorganizations, there are cases where part of our recovery is equity.

We will try to do whatever we can to maximize the value to the Pension Insurance program, and that is usually taking hard cash, if we can get it. We would prefer not to take paper if we could avoid it.

Senator BINGAMAN. If you have any more thoughts on that as this is considered, I would be anxious to see them.

One other aspect of your proposal that I had some concern about. As I understand it, you have a new provision in here to limit the ability of corporations to have preferential funding for executive compensation, but just in certain circumstances.

There are many other circumstances where you are limiting the ability of a company to increase benefits for employees, but doing nothing to restrict the ability of the company to provide preferential funding for executive compensation.

Why is what is good for the goose not good for the gander? If we are going to limit the ability of regular employees to get increased benefits, why should we not have the same limitations on executive compensation in all circumstances?

Ms. COMBS. We agree with your premise, and we are motivated by the "what is good for the goose is good for the gander" situation. We also recognize that, in most circumstances, now, the top executives in a company are not receiving most of their retirement income from the qualified pension plan, it is coming through executive compensation.

So, we analogized the prohibition against preferential funding to the freezing of the plan. It is a pretty draconian event. Companies do not generally move to set aside funding for this non-qualified executive compensation until they are facing bankruptcy or until they think they might actually be at risk.

So, we were targeting it towards that circumstance where we found that there was a real risk of a plan going into bankruptcy. We wanted, at that point, to freeze the plan and not allow them to fund executive compensation.

They do not really take that step, in our experience, to secure the non-qualified executive compensation until they are faced with that kind of a situation, so it was not a real threat. That was our thought process in what we chose to do, but we are happy to discuss this issue with you as we go forward.

The CHAIRMAN. Thank you, Senator Bingaman.

Now, Senator Wyden, then Lott, Rockefeller, and Snowe.

Senator WYDEN. I want to ask about this question of forward-funding as well. Let me start with you, if I might, Mr. Belt.

It seems to me that, as much as anything, what we ought to be doing is going back to the old-fashioned principle of saving for a rainy day. That is not what we have done, for years, with pension law.

Now, last year's committee bill and the administration's proposal both suggest allowing companies to contribute more during good economic times. But my sense is, that is not going far enough. Just allowing it, I think, means that we are not going to get a whole lot of that new economic thinking into our system any time soon.

Would it not make sense for our committee to look and to work with you all on specific incentives to get those kinds of savings-for-a-rainy-day programs in place?

Mr. BELT. Senator, we believe there are outstanding incentives in place in the administration's reform proposal to actually fund up. Not only do we have a required 7-year period over which to amortize under-funding, the increase in the maximum guarantee limit, maximum contribution limit, provides, I think, powerful incentives for companies to be able to pre-fund those obligations.

Number one, they shorten the amortization period. If they put money above the minimums, they shorten that 7 years by 1, 2, or 3 years, or they can totally pre-fund the obligation. Two, they get a tax-deductible contribution for those dollars.

Senator WYDEN. How much is that tax deduction?

Mr. BELT. They can take it up to 130 percent of their funding target and always can fund fully to at-risk liability. So, that is a substantial increase over current law, but I would defer to my colleague, Mr. Warshawsky.

Mr. WARSHAWSKY. If I understand your question, basically the way we have——

Senator WYDEN. My question, as I read the proposal, is you all allow people to make these forward contributions, but those really are not the kind of incentives that I think are going to send a big message out there; that is just garden-variety common sense.

Mr. WARSHAWSKY. Well, they would get a dollar-for-dollar reduction in the amount of the variable rate of risk-based premium, so if they are going to complain about premiums being too high, they can directly reduce the amount of premiums they would pay. So, we think that creates a very powerful incentive to go ahead and put money in now.

They could also improve their credit rating in the capital markets. They could enhance their ability to offer new benefits to employees. There are a whole host of incentives built into the administration's proposal.

Ms. COMBS. We are also moving the target up. Under current law, they have funded 90 percent of what is called current liability. We are having a tougher target, having them get to 100 percent. So, there is some of that, too.

Senator WYDEN. I will follow up with them on that.

Ms. COMBS. We would be happy to work with you on these issues.

Senator WYDEN. Let me ask you another one. Part of your mission is to try to promote defined benefits. As I look at this proposal and the debate that has surrounded it, it is like you all assume that the defined benefit is going to be a dinosaur. You are writing it off as an artifact of history.

I think we all understand that times have changed, but I am not one who is just going to write them all off. What are you prepared to do as part of this newly defined mission to promote something that I, and I think a lot of Americans, think is important, and that is to do everything possible to promote defined benefits?

Mr. WARSHAWSKY. Senator, I believe that our proposal actually has not written off the defined benefit system. Quite the contrary. But one has to recognize that in order to encourage the formation of new plans—and these might be plans offered by small companies, but small companies eventually become large companies and increase their employee base—we have to simplify the system.

We have a remarkably complex set of rules, and we feel as if we have achieved a lot of simplicity and rationalization of the rules, which will be particularly beneficial for small plan sponsors.

The other thing we have to recognize is that there is an overhang. The PBGC deficit and the exposure that the PBGC has, really have to be dealt with in order to invite new plan sponsors to come into the system.

Senator WYDEN. So your theory is that you have a plan that will deal with the PBGC deficits in the short term, and as a result of

that, defined benefits are not going to be dinosaurs headed for extinction?

Mr. WARSHAWSKY. Well, I would say that the idea is to work off the PBGC deficit in a prudent and timely manner.

Senator WYDEN. I will tell you, and I intend to work with you on the questions I am talking about, I also happen to think that Senator Bingaman is raising an important point because it sure looks to us like a lot of these turn-around specialists are getting a sweetheart deal.

They come on in there, take somebody with really nothing but assets, send you the pension costs, and walk away with the profits. So, I am going to be interested in exploring that and these other two matters with you.

I am particularly concerned about that second question I asked, because as I look philosophically at where we are headed, I am not prepared to say—and we may not have as many defined benefit plans as in the past—as a formal policy statement, just not going to say defined benefits are a dinosaur.

I really think that that underlies much of the administration's thinking, and I am troubled by it. You all are shaking your heads, and we can debate it as we go forward in this discussion. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lott?

Senator LOTT. Thank you, Mr. Chairman.

Ms. Combs, let me begin with you. You identified three things that your proposal, the administration's proposal, would attempt to do. One of them is benefits limitations. Briefly touch on the other two. There was the other one with regard to the executive benefits package.

Ms. COMBS. That is part of the benefit limitations, Senator.

Senator LOTT. All right.

Ms. COMBS. The others were disclosure, better transparency and more disclosure to workers and investors and regulators. The third was the premium proposal, to increase the flat-rate premium from $19 to $30 and change the risk-based premium.

Senator LOTT. Mr. Warshawsky, is it true that, under the current situation, when you are doing well you actually pay less, and when you are doing poorly you have to pay more? There is an inversion there that guarantees failure when you get into the tank, so to speak. When you start sliding down, you have to pay more and it keeps forcing you down toward bankruptcy. Right?

Mr. WARSHAWSKY. Under current law, Senator, that is largely correct.

Senator LOTT. Does the administration's proposal do anything about that?

Mr. WARSHAWSKY. We believe it does. Number one, we remove the mechanism of the deficit reduction contribution which causes that problem. Number two, we have expanded the amortization period to 7 years. Number three, a lot of times that problem is caused in sort of a perverse way by the masking of the true status of the plan.

The plan sponsor is lulled into thinking—and perhaps others are lulled into thinking—that the plan is well-funded, when in fact it

is not. When the smoothing mechanism expires, then, lo and behold, all of a sudden it has to make massive contributions.

So, we feel that it is very important to have an accurate depiction of the plan's financial status and then to allow plan sponsors to manage that appropriately.

Senator LOTT. I think we ought to look at that very closely. I want to make sure that you have done enough there to deal with that problem.

I do, particularly, like the idea of the benefits limitations because I do think that has driven a lot of the companies into the situation they are in. I mean, they made commitments on benefits that they should never have committed to and cannot afford, cannot pay. It is driving them into bankruptcy. But the fact of the matter is, they are there.

Particularly, Mr. Belt, with regard to, I guess, some steel companies, but airlines, it looks to me like you have not taken cognizance of their situation and the fact that there are two airlines already in bankruptcy, and one, two, three, four others could be in the same situation. It almost looks like you want to put them into bankruptcy and force them to terminate their plans. That could not be a healthy situation for PBGC, correct?

Mr. BELT. Very much to the contrary, Senator. We have been obviously fighting U.S. Airways and United Airlines in bankruptcy, indicating, particularly in the case of United Airlines, we do not believe they necessarily meet the distressed termination criteria that are established in law. There is no question that the airlines represent a huge chunk of exposure for the Pension Insurance program, about $31 billion at the end of last year.

The last thing we want to do is have to take over those liabilities. It would be much more preferable if those companies were able to maintain their pension plans, honor the promises they have made to their workers and retirees, and do that and stay out of bankruptcy and stay away from the Pension Insurance program.

Senator LOTT. But I do not think that is what you do here. It looks to me like you really have not taken cognizance of their situation. They want to pay their benefits, but I presume they want to freeze them and pay back what they owe over a period of time. Seven years is probably not enough to deal with that.

Mr. BELT. Well, the problem is, current law right now requires them, particularly if they fall under the DRC, the deficit reduction contribution rules, to pay off those obligations sometimes in much less than 7 years. That is under current law.

Senator LOTT. And we know that that is not adequate and is a real problem, and we want to change that.

Mr. BELT. The administration's proposal says we will actually give you 7 years to pay off those obligations. But we are also trying to address the problems, as I noted at the outset with respect to United and others—and United is only illustrative—of what led them to get to the point where, for example, in United's case, they are $8 billion under-funded when they were not putting any dollars into the pension plan, even when they were fairly healthy and negotiating new benefit increases when they were substantially under-funded.

Senator LOTT. But when did PBGC know that they were not paying what they were supposed to be? It seems to me that is when you should have acted. Somebody should have stepped in and said, you have got to be paying your obligations here.

Ms. COMBS. The law allows it.

Mr. WARSHAWSKY. The law allows it.

Senator LOTT. It allows them to stop paying because they have the credits built up.

Ms. COMBS. The credit balance.

Mr. WARSHAWSKY. Yes.

Senator LOTT. Which guarantees that they will be in the situation they are in now. I am being told that what you are proposing is not going to help the airlines. They want to pay the benefits they say they owe, but they want to freeze the plans immediately and then have a period of time longer than 7 years to get back into the position they need to be with regard to what they owe.

Mr. BELT. Well, I certainly appreciate the difficult challenges that some of the airlines are facing, but they have the complete authority under current law to freeze their plans.

That is governed by the collective bargaining agreement. So if they can negotiate with their unions, and the pilots have expressed some willingness to do that, they can freeze their plans under current law.

They would have, under the President's proposal, 7 years to make up that deficit. Also, we're not changing the process for obtaining waivers in instances of temporary business hardship, if that is what the case is, to extend that out a little bit further.

In those cases, you sit down with the Internal Revenue Service and the PBGC to negotiate the terms of those waivers.

Senator LOTT. Since I see the red light, I will just conclude here. For 2 years, I chaired the Aviation Subcommittee, a Commerce Committee. I follow what is happening there. I really want our airline industry to be able to return to profitability. They have got lots of problems, from fuel, to government fees for security. But this is a huge problem, too.

If we do not address this in a way that people get the benefits they are entitled to, but also make sure we have set up a glide path for them to be able to gain altitude, we are going to have a lot more debt dumped on PBGC. So, I do not think the administration has done enough in this area.

I am not sure I am expert enough yet to know what to do, but I think we should address the pension plans, and more attention to the airline industries is going to have to be included as part of that. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Lott.

Now, Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Mr. Chairman, Senator Lott was on the point that I wanted to get at too, but he expressed it extremely well. So I guess what I can best do, is say that I think there are some very good things that Senator Bingaman said about this, about the plan here.

But airlines are different. International commerce shuts down, at least within a fairly transnational area. It just flat-out shuts down. What it does to the markets is far greater than what happens if

some other kind of industry goes into bankruptcy and has to depend upon the PBGC. It is unique. It is psychological.

I would say to you, Mr. Belt, you talk about, they negotiate their way out with their unions to get sacrifices. That has been, actually, quite extraordinary, it seems to me, the amount of give-back and savings on both sides that have been allowed to happen.

But I would say that Senator Lott and I—we have not discussed this directly—are both very, very worried that we could have a system here where you have got a sudden thing, like something gets caught up in a vortex, and if one industry, a particular type, an airline industry, a particularly sordid bankruptcy happens—which of course has happened—but it has been able to have been absorbed, but there comes a point where you cannot absorb anymore.

Let me make the opposite point. In the railroad business, when I came here 20 years ago, there were 50 Class A railroads. There are now four, and about to be two. In that case, that is tremendous efficiency. Now, I might have some other problems with that, but the airline case is the other.

They cannot go down to one or two airlines. There has to be the alternatives. They have to divide up the country in various ways. There has to be a hub-and-spoke system. I am genuinely worried about what happens to them if they get caught in this vortex of downward spiral. I just would say that because I think that Senator Lott asked my question very, very well.

The other thing is highly speculative, but it is of interest to me. Senator Baucus was indicating we were here 10 years ago worrying about the PBGC, but it was only, what, 5 years ago that the PBGC had about a $9.7 billion debt, and it is now over $23 billion.

You have a lot of industries within the group, which are now trying to make it, which are funded by junk bonds. If you had a situation wherein a great quantity of those folded, you could—and this is just calculation from within my office—get yourself up to a $90 billion deficit very, very quickly.

I do not know what you do at that point. The reason I am asking is, you are not borrowing money at this point. If you got into those kinds of numbers, let us say we hit a really rough patch. And it has been dicey over the past 30 years, really going back to the late 1970s and early 1980s, and on. The economy has been very much up and very much down, but we have not really had the consequences because we have not been trying to do as much as we are trying to do now, and therefore having less Federal support.

At what point do you see the PBGC, if you see it at all, having to go outside to borrow money? If that were to be the case, from whom might it be? A very esoteric question, but it interests me.

Mr. BELT. Senator, you have raised a host of issues, and we try to address that. I mean, one thing to note is that, by law, under ERISA, we are supposed to be self-financing. We have no claim upon the American taxpayer and our only source of revenues is premium revenues, as well as returns on assets that we take over. I think that is the key point.

Many of the folks who argue for the status quo suggest that nothing needs to be done. This $23 billion deficit is somehow a chimera, that we can wait until tomorrow to put this off, because the fact is, whenever we take over a terminated plan, we take over the

assets of that plan. That allows us to write checks to people who are getting benefits at that point in time.

The problem is, in each and every instance when we take over a terminated plan there are a lot more liabilities there than the assets we take over, but those are paid off over a long period of time.

So, theoretically we could continue to grow in all the wrong ways, continue to take on a lot more assets in these plans that are terminated. We still have the ability to write checks for a period of time, but the hole gets bigger, and bigger, and bigger, and bigger. Somebody has to pay that at some point in time.

The fundamental question is: who pays that? We are trying to make sure that the hole does not get any bigger, and that is what the administration's proposal is all about.

In a very measured way, we begin to fill that hole, so we never have to get to that day of reckoning where we have that $50, $90, or $100 billion-plus deficit that some have suggested could come by doing nothing.

Mr. WARSHAWSKY. Senator, I would also add that, given the stage that we are in in the economic cycle, we have recovered, and corporate profits are at an all-time high as a percent of GDP. So, actually the timing is very good. This is a good time to fund the plans, and companies have excess cash. Many companies have, in fact, put money in their plans; General Motors made a very substantial contribution. We really would like to see that be the solution.

Senator ROCKEFELLER. All right. My time is up. Thank you.

Senator LOTT. Thank you very much, panel, for your participation today. I am sure we will be talking a lot more about this in the weeks and months ahead.

Now, at this time I would like to introduce our second panel of witnesses as this panel leaves and the new panel comes forward. I would just introduce them, briefly.

First, we welcome Larry Zimpleman, testifying on behalf of the Business Roundtable and a broader umbrella of business groups, including the American Benefits Council, the American Council of Life Insurers, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers and the U.S. Chamber of Commerce. An impressive list.

Larry is president of the Retirement and Investor Services at the Principal Financial Group in Des Moines, Iowa. I suspect that last point explains why Chairman Grassley would want Mr. Zimpleman to be here.

We will then hear testimony from Alan Reuther, who is the Legislative Director for the International Union of United Automobile, Aerospace, and Agriculture Implement Workers of America, commonly known as UAW.

Last, we will hear testimony from Randall S. Kroszner, Professor of Economics at the University of Chicago Graduate School of Business.

Thank you all, gentlemen, for being here. We hope that you will continue to add to our efforts to really fully understand what is going on with these defined benefit plans and what is happening at the PBGC.

Mr. Zimpleman?

STATEMENT OF LARRY ZIMPLEMAN, PRESIDENT, RETIREMENT AND INVESTOR SERVICES, PRINCIPAL FINANCIAL GROUP, DES MOINES, IA, ON BEHALF OF THE BUSINESS ROUNDTABLE

Mr. ZIMPLEMAN. Thank you, Senator Lott, members of the committee. It is a pleasure to be with you to speak to this topic today.

As you said, Senator Lott, I am Larry Zimpleman, president of Retirement and Investor Services at Principal Financial Group in Des Moines.

I am here today on behalf of the Business Roundtable, an association of CEOs from the largest employers in the world. The American Benefits Council, the ACLI, the ERISA Industry Committee, the National Association of Manufacturers, the Financial Executives Institute, and the U.S. Chamber of Commerce also joined in my testimony today.

We commend Chairman Grassley, Ranking Member Baucus, and all of you on the committee for having this hearing and for tackling pension reform. Your leadership on retirement issues in recent years has been invaluable, and we look forward to continuing to work with you to build a sustainable and vibrant defined benefit system.

Defined benefit plans cover over 34 million American workers today, and they have $1 trillion of assets invested in our capital markets to support their benefit obligations. As we debate possible changes to the funding rules, we need to find solutions that allow for stable, predictable, and responsible funding rules.

In fact, we need to make changes that will promote greater defined benefit coverage, especially among smaller and medium-sized employers.

There are several elements to the administration proposal that we believe will be positive for creating a healthier defined benefit system, particularly, improved disclosure to plan participants and changed tax rules to allow plan sponsors to make larger contributions during good economic times. This is covered in detail in our written statement.

However, my comments today will focus on those areas of the administration proposal that we believe deserve more study and thought. As a starting point, our top two priorities for pension funding reform are, first, making the long-term corporate bond rate permanent. It is critical that employers be able to project pension contributions beyond next year.

We also believe it is important to conform the interest rate for lump-sum distributions to the same long-term corporate bond rate so that plan funding is not harmed through the choice of lump-sum distributions.

Second, we need to confirm the rules for hybrid defined benefit plans, which today cover over 7 million American workers and which provide appropriate alternatives to traditional defined benefit plan design.

Our written statement discusses the principles that we believe should underlie pension fund reform. In the interest of time, I will not repeat those principles here today, but I would like to touch on the five specific areas of concern that we have with the administration proposal.

First, the administration proposal removes the ERISA funding rules which are based on long-term, predictable results and replaces them with methodologies that are based on more of a spot-rate methodology.

As a threshold matter, spot-rate methods do not mean tougher funding standards than ERISA methods. However, the spot-rate methods will cause more volatility in pension contributions and will create greater cyclical effects on the U.S. economy.

Our written statement mentions economic analysis that we have commissioned that estimates that, had the proposed funding rules been in effect in 2003, it would have cost the U.S. economy over 300,000 jobs.

Second, the proposed funding rules advocate the use of a yield curve for determining plan liabilities versus the current use of a single rate, which is the long-term corporate bond rate, as I mentioned a minute ago. Since the yield curve is a more complex methodology, it is an issue, particularly for small and medium plans.

From the modeling we have been able to do on the proposal, we also believe that if the yield curve were imposed today, it would mean that the typical mature plan would see a decline in its funding status of approximately 10 percent, as the overall rate produced by the yield curve is approximately 1 percent lower than the current long-term corporate bond rate.

If a yield curve methodology is to be used, it must be done in a manner that produces an economic trade-off to a single rate for the typical mature plan. The yield curve methodology must not be a back-door mechanism to create lower interest rates for purposes of determining the value of plan liabilities.

Third, it is not clear from the analysis that we have been able to do that the administration proposal works well in periods of higher interest rates, similar to what the U.S. economy experienced in the 1980s. We believe that more work and analysis is needed in this area.

Fourth, we acknowledge that the PBGC liability has increased in the last few years, particularly since 9/11, but it is not clear that the magnitude of the increased liability is as significant as has been portrayed.

Even the PBGC acknowledges there is no near-term financial issue. We believe that the best long-term solution for the financial health of the PBGC is to have a healthy and growing defined benefit system, and we do not believe that this proposal will create that.

We are particularly concerned about the PBGC proposal to introduce creditworthiness into the funding, premium, and benefit determinations. Not only are there practical issues, which we lay out in our written statement, but the proposals ignore a basic principle of U.S. pension law that requires plan assets be held in trust. So, credit rate is not directly tied to a plan's ability to pay promised benefits.

Fifth, the PBGC proposes an increase in the base annual premium from $19 to $30, and to also index the base premium to wage inflation. It also proposes to give the PBGC board the authority to set the variable-rate premium at the level it believes is appro-

priate. As we mentioned previously, it is not clear that the magnitude of the PBGC deficit warrants these major changes.

There is no question that moving the base premium up by over 60 percent will have a chilling effect on current defined benefit sponsors or future employers who might otherwise consider establishing a defined benefit plan.

For example, our analysis indicates that small plans—which we define, in this case, as plans under 100 lives—have not contributed at all to the current PBGC financial deficit, yet they are being asked to help contribute to fund the deficit.

As a matter of principle, we do agree with the Department of Labor and PBGC that benefit promises must be funded. We support finding ways to prevent plan sponsors from making benefit promises they do not intend to keep. However, we believe it is possible to create more targeted reforms to deal with PBGC's financial challenges.

Mr. Chairman and members of the committee, in making changes to the defined benefit funding rules, it is vitally important to recognize the impacts these changes can have on the U.S. economy, our capital markets, and the current employers who are participating in the defined benefit system today. Unintended consequences could be devastating.

As this proposal moves forward, we look forward to working with this committee, the administration, and other regulatory agencies to refine these ideas to achieve their intended results, while maintaining the overall health of our defined benefit system.

Thank you, Mr. Chairman, for allowing me to present the views of the business community, and I would be happy to answer any questions you might have.

The CHAIRMAN. Thank you, Mr. Zimpleman.

[The prepared statement of Mr. Zimpleman appears in the appendix.]

The CHAIRMAN. Now, Mr. Reuther?

STATEMENT OF ALAN REUTHER, LEGISLATIVE DIRECTOR, UNITED AUTO WORKERS, WASHINGTON, DC

Mr. REUTHER. Thank you, Mr. Chairman. The UAW appreciates the opportunity to testify before this committee on the administration's pension proposals.

It is important to recognize at the outset that there is no immediate crisis at the PBGC. As the administration has admitted, the PBGC has sufficient assets to pay all guaranteed benefits for many years to come.

There also is general agreement that the PBGC's projected deficit is directly attributable to the widespread bankruptcies in the steel and airline industries.

UAW supports balanced legislation to strengthen the funding of pension plans and to bolster the PBGC, but we strongly oppose the pension proposals advanced by the administration.

In particular, we oppose the funding proposals that would: mandate a yield curve interest rate assumption; establish new funding rules based on spot valuations of assets and liabilities with no smoothing mechanisms and with funding targets tied to a company's credit rating; eliminate credit balances entirely; place arbi-

trary limits on benefits provided by pension plans; and prohibit plans from even offering plant shut-down benefits.

In addition, we oppose the proposals relating to the PBGC that would sharply increase the flat and variable premiums paid by plan sponsors and link the variable premium to the credit rating of a company, reduce the guarantees provided to workers and retirees, and give the PBGC a lien in bankruptcy proceedings for any unpaid pension contributions.

The administration's proposals would result in highly volatile funding requirements, making it more difficult for companies to plan their cash flow and liability projections.

In addition, these proposals would impose significant economic burdens on many employers, punishing companies that are already experiencing economic difficulties. The proposals would exacerbate the competitive disadvantage facing many older manufacturing companies with higher legacy costs.

The proposals also would discourage companies from contributing more than the bare minimum during good economic times, and instead impose sharply higher counter-cyclical funding requirements during economic downturns.

At the same time, the proposals would cut back benefits and guarantees for workers and retirees, thereby reducing the adequacy of their retirement income. The proposals would also cause many retirees to lose their health insurance coverage.

Taken together, the UAW believes the administration's proposals would result in more bankruptcies, more plant closings, and job and benefit loss. This, in turn, would lead to more pension plan terminations and the transferring of even greater unfunded liabilities to the PBGC.

The proposals also would provide a powerful incentive for employers to exit the defined benefit pension system, to the detriment of workers and retirees, and potentially creating a death spiral for the PBGC.

Instead of these counter-productive proposals, UAW urges this committee to approve a more balanced package of reforms that will improve the funding of pension plans, thereby enhancing the security of benefits and reducing the future exposure of the PBGC without punishing employers, workers, and retirees.

This includes funding reforms that would make permanent the long-term corporate bond interest rate assumption that was enacted last year; modifying the deficit reduction contribution rules so they apply to a broader universe of plans and are triggered more quickly when a plan becomes less than fully funded, but also provide a smoother path towards full funding; shortening the amortization period for plan amendments from 30 to 15 years; and requiring employers to value new credit balances according to actual market performance.

In addition, the UAW supports the establishment of a new plan reorganization process for under-funded plans in situations where the employer has filed for chapter 11 bankruptcy.

We believe this type of process could be a powerful tool for enabling struggling employers, like many of the airline companies, to be able to continue their pension plans while protecting workers and retirees to the maximum extent feasible, but also preventing

unfunded liabilities from being transferred to the PBGC. Thus, this approach would be beneficial for workers, retirees, for companies, and for the PBGC.

Finally, the UAW believes the best way to deal with the steel and airline liabilities that have, or will be assumed by the PBGC, is to have the Federal Government finance these liabilities over a 30-year period.

This would be far less costly than the administration's own proposal to increase significantly the amounts that can be contributed to individual retirement and savings accounts.

In our judgment, this would be far better for workers and retirees, for employers, for the PBGC, and the entire defined benefit pension system than the administration's proposals.

In conclusion, the UAW appreciates the opportunity to testify before this committee, and we look forward to working with the members of this committee as you consider these issues. Thank you.

The CHAIRMAN. Thank you, Mr. Reuther.

[The prepared statement of Mr. Reuther appears in the appendix.]

The CHAIRMAN. Now to Mr. Kroszner.

STATEMENT OF RANDALL S. KROSZNER, PROFESSOR OF ECONOMICS, THE UNIVERSITY OF CHICAGO GRADUATE SCHOOL OF BUSINESS, CHICAGO, ILLINOIS

Mr. KROSZNER. Thank you very much, Mr. Chairman, Senator Lott, and the members of the committee. I am delighted to be able to speak about these issues before you.

I applaud the committee for taking up this very, very important and complicated issue at this time because I believe the system is in crisis and in urgent need of fundamental reform. It is a ticking time bomb waiting to explode. The longer we wait to defuse it, the more costly it will be for everyone.

What I want to do is draw some parallels between what happened in the savings and loan industry and with PBGC today. I call this section "Deja Vu All Over Again: Don't Let the PBGC Become the S&L Crisis of the New Millennium."

In my more detailed written remarks, I go through many of the parallels between the Federal Savings and Loan Insurance Corporation—the so-called FSLIC—and the PBGC of providing insurance guarantees, not allowing the premiums to vary with risk, seeing a series of economic shocks that happened in the savings and loan industry that have also happened in the broader economy recently to push the insurance agency into deficit.

But, as I note, one of the most disturbing parallels is that many observers, both back in the 1980s for the FSLIC, and for the PBGC today, acknowledge that the agencies face some challenges currently, but they said that the trouble is simply a temporary phenomena.

As the economy recovers, everything will be fine. Just wait and hope with fingers crossed. This is the so-called forbearance policy that ended up costing American taxpayers $100 billion in the savings and loan industry.

The sad history of the thrift crisis demonstrates that we should not wait, we must act now. Why? Because the problems will only

grow larger. As you heard from the earlier panel, there are sizeable deficits currently at PBGC. The projected deficits, both by PBGC making reasonable assumptions and other nonpartisan agencies, are on the order of $90 to $100 billion.

The reason that this will grow is that there is a moral hazard problem that is a bad incentive problem of the current system for employers to take excessive risks, for employers to under-fund their pension obligations and to issue larger pension benefits as the company is getting into difficulty, trying to make a trade-off, offering up the Pension Benefit Guaranty Corporation's guaranteed benefits when they do not have the cash today, and the shut-down benefits that can then be guaranteed by the PBGC. These are all classic examples of moral hazard problems.

We have seen, in the airline industry, a number of examples of unions taking out lump-sum benefits just before bankruptcy, or even as firms are entering bankruptcy, taking the money out as quickly as possible. Again, another classic problem of moral hazard.

To avoid an enormous and inappropriate taxpayer-financed bailout of the PBGC at some point, action must be taken swiftly. I think we have the blueprint for that before us.

The Senate has, little more than a decade ago, passed the Federal Deposit Insurance Corporation Improvement Act, the so-called FDICIA, of 1991. It introduced a number of important changes that dramatically reduced the problems, and we have not had problems in the savings and loan industry or in the broader banking industry since.

Even though we have had recession, we have had 9/11, we have had a number of shocks, with volatility in interest rates, the industry has stayed quite healthy through this.

What are these steps that FDICIA had, and how can they be applied to the current situation with PBGC?

First, FDICIA permitted insurance premiums to increase to provide greater assets for the Deposit Insurance agency to cover its obligations. This is an important first step. Put the insurance agency on a solvent basis.

How do you do that? By charging actuarially fair premiums. If there are greater risks, you pay more. That is the appropriate thing to do. The overall level needs to rise.

Second is the specific adjustment for risk. Right now, we do not have appropriate risk adjustments in the system, so this is a terrible penalty for the good actors, for the employers who are doing the right thing, who are funding their pensions well, who are acting in the right way.

What you need to do is reward those people, and punish the people who are undertaking riskier activities, who are doing things that are putting the pension system at risk, by charging higher returns.

So, taking into account things like the risks in the asset portfolio, the likelihood of PBGC take-over, such as the probability of financial distress, the extent of the funding gap, are perfectly reasonable things to do.

In addition, what FDICIA did is prompt corrective action. And Senator Lott brought up exactly these issues before. Why is the PBGC not acting earlier? Well, they do not have the legal authority

to do so. The regulators did not have the legal authority to do so during the savings and loan crisis. However, what FDICIA did is allow for prompt corrective action.

When plans are going down and getting into trouble, what do you do? You start to put restrictions on the activities. You do not allow for the ability to pull out lump-sum transfers. You do not allow for the ability to offer more shut-down benefits that are guaranteed by the PBGC. So what you need to do is restrict the activities when the moral hazard problems, when the risks, are greatest to the taxpayer.

In conclusion, what I would like to say is that we need to think more broadly here on these issues, I think, to explore some options that might involve greater harnessing of private-sector involvement in order to maintain the security of the pension system without encouraging undue risk.

One question that arises is whether government-sponsored enterprise is the best way to achieve these objectives. For instance, the Congress has successfully moved Sallie Mae from a government-sponsored enterprise that guarantees student loans into the private sector. In the home mortgage area, private mortgage insurers provide guarantees to allow many purchasers of homes who otherwise could not receive a mortgage.

Investigating the feasibility of some forms of private insurance over the purchase of private annuities by employers for their employees would be a valuable addition to the immediate reforms of the PBGC.

Thank you very much for the honor of allowing me to express my views before the committee, and I would be happy to answer any questions you might have.

[The prepared statement of Mr. Kroszner appears in the appendix.]

The CHAIRMAN. All right.

Now, if I do direct questions to any one of you, since we do have a diverse panel and opinions, if anybody wants to enter in, you can enter into the discussion. We do not have anything to hide here, and we want to get all the opinions out on the table.

I am going to start with Mr. Reuther. In your prepared statement, you make the argument that because we bailed out the savings and loan situation, we should also be willing to bail out PBGC.

I think most people would say that we ought to be doing everything we can to avoid such a bail-out like that in the future, particularly by the taxpayers. Should we not be taking steps now to avoid another savings and loan situation?

Mr. REUTHER. Yes. That is why we suggest that there should be a balanced package of funding reforms to improve the funding in the rest of the defined benefit system. That would be good for workers and retirees and would reduce the exposure of the PBGC. But you still have the question then, what do you do about the steel and airline liabilities that have already been put on the system?

Our point is, trying to push those costs onto other employers, the rest of the premium payers, will be counterproductive and will really, in the end, cause a death spiral in the overall defined benefit pension system.

The CHAIRMAN. Anybody else want to enter into that?

Go ahead, Mr. Kroszner.

Mr. KROSZNER. If I might, Mr. Chairman. It is extremely important to avoid what happened in the 1980s with the savings and loan crisis. We must avoid the taxpayer-financed bail-out. As the head of the PBGC said, there is no obligation on the part of the government to do so, but there may be pressures to do so.

The best way to do it is to pursue exactly what the Senate and House did in 1991, set in a series of protections that will reduce the likely exposure of the taxpayer, reduce the risks in the system. The FDICIA is a good model for that.

I think many of the administration's proposals that involve reducing the ability to take out lump-sum transfers, to provide shutdown benefits guaranteed by the PBGC as a firm is getting into trouble, are exactly in the right direction. Protect the taxpayer. We can do it, but we need to act now.

The CHAIRMAN. I would like to have each of you respond to this. This is the so-called "perfect storm" situation for pension funding that is said to be the result of historically low interest rates and the bear market after the late 1990s stock boom.

Today, though, we have seen 2 years of rising stock markets. For much of the last 2 years, we have seen stock prices really rise quite dramatically, from their low, at least. In addition, interest rates have stayed low for a considerable period of time. Many experts believe that interest rates may stay quite low into the future.

In other industrialized nations, major countries like Japan and Europe, interest rates are often even lower. Is the "perfect storm" analogy really correct in today's environment?

Mr. ZIMPLEMAN. Well, Senator, I will make a couple of comments on that. I mean, I think as you evaluate the current deficit, whatever level that may be, of the PBGC—I know they've reported it at $23 billion, and as the information around, whether it is $450 billion of under-funding or whatever the level is purported to be—I think it is important, quite frankly, to recognize what we are using as our measuring stick and to recognize that, as we look at the change—for example, the change in PBGC liability from only 3 or 4 years ago when it was $9 billion in surplus to $23 billion in deficit—I think it does beg the question as to what percentage of that change is a result purely of interest rate changes, and what part of that change is attributable to new termination liabilities that PBGC has taken on.

So I would argue that, in crafting solutions to this, it is important to be very judicious and to be very detailed and not to overreact to the particular moment in time where we sit with interest rates.

The CHAIRMAN. Mr. Reuther, if not being repetitive, I would like to have your comment.

Mr. REUTHER. It is important that there be a proper valuation of the PBGC's liabilities, but we do not think this is something that will just go away as interest rates change. As I indicated before, we think there is a need to strengthen the funding of plans.

But also, getting back to, why does the PBGC have this deficit, there is just no denying that something happened in steel and in airlines that was different than anything they had ever seen be-

fore. We think Congress needs to take that into account in deciding how to deal with this.

The CHAIRMAN. Mr. Kroszner?

Mr. KROSZNER. Well, people had made precisely the same arguments in the early 1980s: this is just a special circumstance with respect to interest rates; things will get better, we just need a little bit more time. The problem was, we had more time and the problem grew greater.

There are certain special circumstances at any particular point in time, but the fundamentals are wrong in the way that the PBGC is set up. There is a fundamental moral hazard problem and that needs to be addressed.

The CHAIRMAN. Mr. Zimpleman, Principal Financial has had great success as a leader in delivering retirement plans to businesses and individuals around America. Principal has also had particular success in hard-to-reach small- and medium-sized company markets. Are there ways, unrelated to pension funding rules, that Congress could help promote new defined benefit plan sponsorships?

Mr. ZIMPLEMAN. I think that is a critical question, Senator, because as was noted in the introductory comments, we have gone from 112,000 defined benefit plans 20 years ago to 33,000 plans today, and that has certainly been a contributing factor.

I would again go back and talk, as I said before, about the need for predictability, stability, and responsibility in pension funding. We think, again, our modifications to the administration proposal would help us achieve that.

The second thing is, I think we need to confirm the legality of hybrid plans. Again, I mentioned that in my statement.

The last point I would make is, I think there are some new and innovative defined benefit types of plan designs. For example, we have crafted, working with other actuarial groups, what we call our DBK proposal that allows for a combination of defined benefit and defined contribution programs in a single, integrated package.

We are very excited about that, particularly for small employers, although it would take legislative changes to accomplish that, and we appreciate your support and consideration in the new NESTEG bill. Thank you, Senator.

The CHAIRMAN. For Mr. Reuther and Mr. Zimpleman: in your remarks, you argue that the long-term corporate bond rate is an appropriate replacement for the 30-year Treasury rate.

The yield curve, which was approved by our committee last year, was based partly on interest rates, and partly on the duration of the liability being funded. In other words, you would use a lower interest rate for shorter-term liabilities and a higher interest rate for longer-term liabilities.

This is a concept that anyone who has taken out a mortgage would understand. Why should companies with younger workforces fund their pension plans under the same assumptions as companies with significantly older workforces? Either one of you can start.

Mr. REUTHER. When you talk about accuracy, we think it is a mistake to only look at interest rate assumptions. There is also the mortality assumptions. It is interesting that the administration has not come forward and said that companies ought to be allowed to

use collar-adjusted mortality tables that would also be more accurate and would recognize, if a company has a blue-collar workforce, more older workers and retirees, that the mortality may be different.

So it seems to us that the administration is being one-sided in its accuracy pronouncements, and it is trying to do that with an eye toward producing things that will help their balance sheet, but are not necessarily in the interest of employers who are trying to maintain the plans, and the workers and retirees.

The CHAIRMAN. Mr. Zimpleman?

Mr. ZIMPLEMAN. Well, Senator, I guess my response to your question would be that the key, whether it is a single rate or yield curve, is really to settle on a methodology that provides a long-term, permanent fix to this particular issue.

I mean, I think that is really the key at the end of the day. The question of whether it is a single rate or a yield curve is something I think that the experts can debate.

I would say, however, that it is not yet clear to us that the extra precision of the yield curve methodology and the complexity of the yield curve methodology generates that much additional value in the calculation of plan liabilities to warrant the complexity, but that is certainly a discussion that we can have.

The CHAIRMAN. Yes.

I am going to ask this question of Mr. Zimpleman, but if other people would want to give their perspective, that would be fine. I ask from the standpoint of you being an actuary and representative of an insurance company. You have, of course, vast experience here.

Certainly, the insurance hazards that PBGC faces would not be acceptable to any insurance company. Why should Congress allow the PBGC to continue to function on such an unsound insurance basis that you could not function under?

Mr. ZIMPLEMAN. I thought, Senator, if I came here all the way from Iowa you would ask me the easy questions instead of asking me the hard questions. [Laughter.]

The CHAIRMAN. Listen, what about a week ago yesterday, all the tough questions you asked me?

[Laughter.]

Mr. ZIMPLEMAN. Yes. I did not have this big of an audience, though, Senator. [Laughter.] Well, again, I think it is a great question. Let me make, perhaps, a few points about that.

As I said in my statement, there is a deficit at PBGC. There is no question about that. The magnitude of that deficit is not exactly clear, but the deficit is larger and it has increased as a result of 9/11.

I think, however, it would be somewhat dangerous for us to think about the PBGC and its operations on exactly the same plane as a commercial insurer. I mean, I do think there are legitimate reasons that you would evaluate those two situations somewhat differently.

PBGC is a government-sponsored entity, as Dr. Kroszner noted. They do perform, I believe, a very valuable public stewardship role, and quite frankly have been quite successful over 30 years.

I think that the key here is to restore the financial health and vibrancy of the defined benefit system, and at the end of the day the focus should be more on that than it should be trying to create solutions that are based on, as Mr. Reuther has noted, a couple of industries that we all know are in great distress.

So, we would rather put the solution on creating a vibrant and healthy defined benefit system, having hybrid plan design be a legitimate approach, and looking for new and innovative ways, such as DBK, quite frankly. I think growth is the best long-term solution.

The CHAIRMAN. Mr. Reuther?

Mr. REUTHER. If I may. I agree with those comments. Congress did not establish the PBGC because it wanted to operate a private insurance company. It was looking at how it could protect the pension benefits of workers and retirees and promote the defined benefit pension system. We think those should continue to be the central focus of Congress.

The CHAIRMAN. Mr. Kroszner?

Mr. KROSZNER. If we look back at the origins of the PBGC, look how Congress decided it should be funded. It should be self-funded. It should not be drawing on taxpayer liability. So, I think your original question of, why should this be operating on a different basis than a private-sector institution is an important one.

I think the original intent of Congress was that it would be self-financing, as profitable, private-sector institutions are. It should be, and exposing the taxpayer to these risks is completely inappropriate.

The CHAIRMAN. All right. I thank all of you. That is my last question. I appreciate your participation.

I did not announce this for the first panel, but they might be acquainted with it. Sometimes you get questions in writing from people that cannot be here, or even follow-up from people who have been here. We would appreciate a response about 2 weeks after you receive the questions. Thank you all very much.

[Whereupon, at 4:12 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Bradley D. Belt

Mr. Chairman, Ranking Member Baucus, and Members of the Committee: Good afternoon. I want to commend you for holding this timely and important hearing, and I appreciate the opportunity to discuss the challenges facing the defined benefit pension system and the pension insurance program, and the Administration's proposals for meeting these challenges.

My colleagues will describe the Administration's comprehensive reform plan in detail, so I would like to take this opportunity to briefly outline some of the reasons why fundamental and comprehensive reform is so urgently needed if we are to stabilize the defined benefit system, strengthen the insurance program, and protect the retirement benefits earned by millions of American workers.

Introduction

Private-sector defined benefit plans are intended to be a source of stable retirement income for more than 44 million American workers and retirees. They are one of the crowning achievements of the system of corporate benefit provision that began more than a century ago and reached its apex in the decades immediately following World War II.

That system, however, has on occasion been beset by problems that have undermined the economic security that workers and retirees have counted on. For example, the bankruptcy of the Studebaker car company in the early 1960s left thousands of workers without promised pension benefits. In such cases Congress has been called upon to safeguard the benefits workers were expecting—indeed, Studebaker was the catalyzing event that led to the passage

of the Employee Retirement Income Security Act (ERISA) and the creation of the Pension Benefit Guaranty Corporation a decade later.

The defined benefit pension system is at another turning point today, and the key issues are largely the same: Will companies honor the promises they have made to their workers? The most recent snapshot taken by the PBGC finds that corporate America's single-employer pension promises are underfunded by more than $450 billion. Almost $100 billion of this underfunding is in pension plans sponsored by companies that face their own financial difficulties, and where there is a heightened risk of plan termination.

Of course, when the PBGC is forced to take over underfunded pension plans, we will provide the pension benefits earned by workers and retirees up to the maximum amounts established by Congress. Unfortunately, notwithstanding the guarantee provided by the PBGC, when plans terminate many workers and retirees are confronted with the fact that they will not receive all the benefits they have been promised by their employer, and upon which they have staked their retirement security. In an increasing number of cases, participants lose benefits that were earned but not guaranteed because of legal limits on what the pension insurance program can pay. It is not unheard of for participants to lose more than 50 percent of their promised monthly benefit.

Other companies that sponsor defined benefit plans also pay a price when underfunded plans terminate. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must ultimately be covered by higher premiums. Not only will healthy companies that are responsibly meeting their benefit obligations end up making transfer payments to weak companies with chronically underfunded pension plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor costs onto the government.

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers.[1] If this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

If we want to protect participants, premium payers and taxpayers, we must ensure that pension plans are adequately funded over a reasonable period of

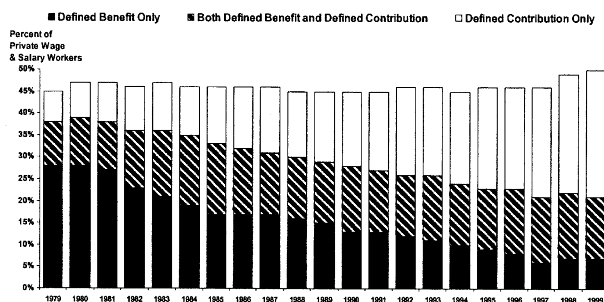
[1] See page 3, *Pension Tension*, Morgan Stanley, Aug. 27, 2004. "[I]n today's environment healthy sponsors may well decide that they don't want to foot the bill for weak plans' mistakes through increased pension insurance premiums."

time. As I will discuss in more detail, the status quo statutory and regulatory regime is inadequate to accomplish that goal. We need comprehensive reform of the rules governing defined benefit plans to protect the system's stakeholders.

State of the Defined Benefit System

Traditional defined benefit pension plans, based on years of service and either final salary or a specified benefit formula, at one time covered a significant portion of the workforce, providing a stable source of retirement income to supplement Social Security. The number of private sector defined benefit plans reached a peak of 112,000 in the mid-1980s. At that time, about one-third of American workers were covered by defined benefit plans.

Pension Participation Rates 1979 - 1999



Source: U.S. Department of Labor
Employee Benefit Security Administration
Abstract of 1999 Form 5500 Annual Reports

In recent years, many employers have chosen not to adopt defined benefit plans, and others have chosen to terminate their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants terminated. In about 99,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. In the remaining 2,000 cases companies with underfunded plans shifted their pension liabilities to the PBGC.

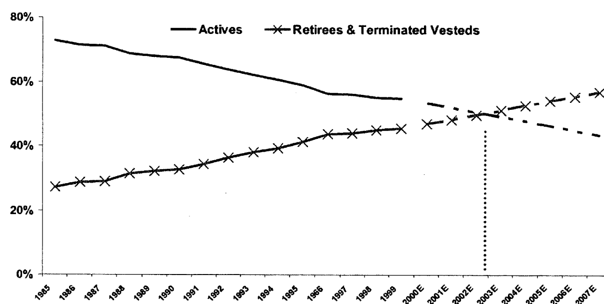
Of the roughly 30,000 defined benefit plans that exist today, many are in our oldest, most mature industries. These industries face growing benefit costs due to an increasing number of retired workers. Some of these sponsors also face challenges due to structural changes in their industries and growing competition from both domestic and foreign companies.

In contrast to the dramatic reduction in the total number of plans, the total number of participants in PBGC-insured single-employer plans has increased. In 1980, there were about 28 million covered participants, and by 2004 this number had increased to about 35 million. But these numbers mask the downward trend in the defined benefit system because they include not only active workers but also retirees, surviving spouses, and separated vested participants. The latter two categories reflect past coverage patterns in defined benefit plans. A better forward-looking measure is the trend in the number of active participants, who continue to accrue benefits. Here, the numbers continue to decline.

In 1985, there were about 22 million active participants in single-employer defined benefit plans. By 2002, the number had declined to 17 million. At the same time, the number of inactive participants has been growing. In 1985, inactive participants accounted for only 28 percent of total participants in single-employer defined benefit plans, a number that has grown to about 50 percent today. In a fully advance-funded pension system, demographics don't matter. But when $450 billion of underfunding must be spread over a declining base of active workers, the challenges become apparent.

Participants in Defined Benefit Pension Plans

[1985 - 2007est.]



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1999 Form 5500 Annual Reports Spring 2004

The decline in the number of plans offered and workers covered doesn't tell the whole story of how changes in the defined benefit system are impacting retirement income security. There are other significant factors that can undermine the goal of a stable income stream for aging workers.

For example, in lieu of outright termination, companies are increasingly "freezing" plans. Surveys by pension consulting firms show that a significant

number of their clients have or are considering instituting some form of plan freeze.[2] Freezes not only eliminate workers' ability to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program.
Given the increasing mobility of the labor force, and the desire of workers to have portable pension benefits that do not lock them into a single employer, many companies have developed alternative benefit structures, such as cash balance or pension equity plans that are designed to meet these interests. The PBGC estimates that these types of hybrid structures now cover 25 percent of participants.[3] Unfortunately, as a result of a single federal court decision, the legal status of these types of plans is in question, further threatening the retirement security of millions of workers and retirees.[4]

The Role of the PBGC
The PBGC was established by ERISA to guarantee private-sector, defined benefit pension plans. Indeed, the Corporation's two separate insurance programs—for single-employer plans and multiemployer plans—are the lone backstop for hundreds of billions of dollars in promised but unfunded pension benefits. The PBGC is also the trustee of nearly 3,500 defined benefit plans that have failed since 1974. In this role, it is a vital source of retirement income and security for more than 1 million Americans whose benefits would have been lost without PBGC's protection, but who currently are receiving or are promised benefits from the PBGC.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Employee Benefits Security Administration (EBSA). Treasury and EBSA deal with both defined benefit plans and defined contribution benefit plans, including 401(k) plans. PBGC deals only with defined benefit plans and serves as a guarantor of benefits as well as trustee for underfunded plans that terminate. PBGC is also charged with administering and enforcing compliance with the provisions of Title IV of ERISA, including monitoring of standard terminations of fully funded plans.

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[2] See, e.g., Aon Consulting, *More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So*, Oct. 2003; Hewitt Associates, *Survey Findings: Current Retirement Plan Challenges: Employer Perspectives* (Dec. 2003).
[3] Table S-35, PBGC Pension Insurance Data Book 2004 (to be issued April 2005).
[4] *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

PBGC is a wholly-owned federal government corporation with a three-member Board of Directors—the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury.

Although PBGC is a government corporation, it receives no funds from general tax revenues and its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for the trusteed plans (generally only pennies on the dollar). The annual insurance premium for single-employer plans has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of 0.9 percent of the amount of a plan's unfunded vested benefits, measured on a "current liability" [5] basis.

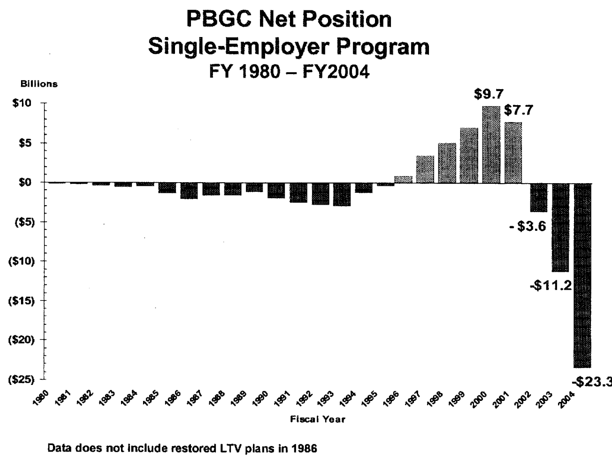
The PBGC's statutory mandates are: 1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of participants; 2) to provide for the timely and uninterrupted payment of pension benefits to participants; and 3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations. In addition, implicit in these duties and in the structure of the insurance program is the duty to be self-financing. *See, e.g.*, ERISA § 4002(g)(2) (the United States is not liable for PBGC's debts).

These mandates are not always easy to reconcile. For example, the PBGC is instructed to keep premiums as low as possible to encourage the continuation of pension plans, but also to remain self-financing with no recourse to general tax revenue. Similarly, the program should be administered to protect plan participants, but without letting the insurance fund suffer unreasonable increases in liability, which can pit the interests of participants in a particular plan against the interests of those in all plans the PBGC must insure. The PBGC strives to achieve the appropriate balance among these competing considerations, but it is inevitably the case that one set of stakeholder interests is adversely affected whenever the PBGC takes action. The principal manifestation of this conflict is when PBGC determines that it must involuntarily terminate a pension plan to protect the interests of the insurance program as a whole and the 44 million participants we cover, notwithstanding the fact that such an action is likely to adversely affect the interests of participants in the plan being terminated.

The pension insurance programs administered by the PBGC have come under severe pressure in recent years due to an unprecedented wave of pension plan

[5] Current liability is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if a plan terminates.

terminations with substantial levels of underfunding. This was starkly evident in 2004, as the PBGC's single-employer insurance program posted its largest year-end shortfall in the agency's 30-year history. Losses from completed and probable pension plan terminations totaled $14.7 billion for the year, and the program ended the year with a deficit of $23.3 billion. That is why the Government Accountability Office has once again placed the PBGC's single employer insurance program on its list of "high risk" government programs in need of urgent attention.



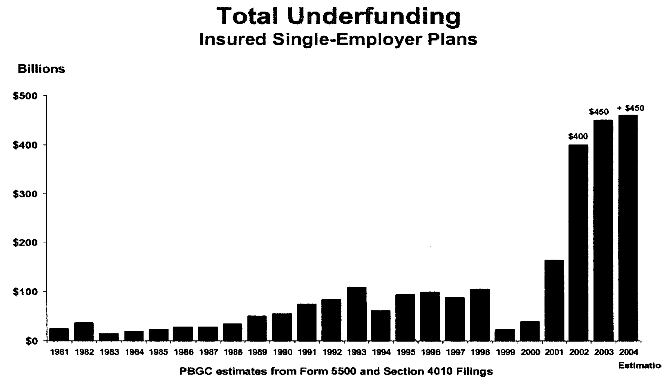
Data does not include restored LTV plans in 1986

Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. However, with $62 billion in liabilities and only $39 billion in assets as of the end of the past fiscal year, the single-employer program lacks the resources to fully satisfy its benefit obligations.

Mounting Pressures on the Pension Safety Net

In addition to the $23 billion shortfall already reflected on the PBGC's balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than $50 billion. Two years later, as a result of a combination of factors, including declining interest rates and equity values, ongoing benefit payment obligations and accrual of liabilities, and minimal cash contributions into plans, total

underfunding exceeded $400 billion.[6] As of September 30, 2004, we estimate that total underfunding exceeds $450 billion, the largest number ever recorded.



Not all of this underfunding poses a major risk to participants and the pension insurance program. On the contrary, most companies that sponsor defined benefit plans are financially healthy and should be capable of meeting their pension obligations to their workers. At the same time, the amount of underfunding in pension plans sponsored by financially weaker employers has never been higher. As of the end of fiscal year 2004, the PBGC estimated that non-investment-grade companies sponsored pension plans with $96 billion in underfunding, almost three times as large as the amount recorded at the end of fiscal year 2002.

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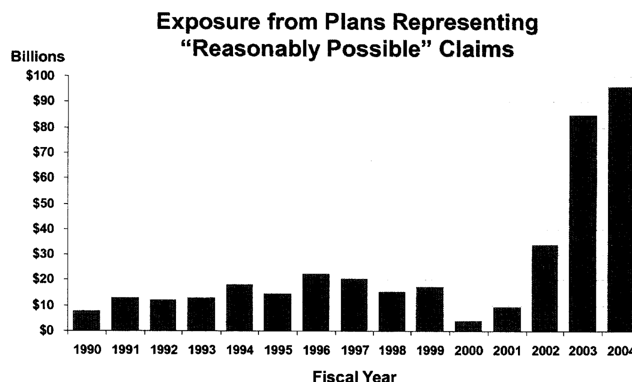
[6] See page 14, *The Magic of Pension Accounting, Part III*, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005). "[F]rom 1999 to 2003 the pension plan assets grew by $10 billion, a compound annual growth rate of less than 1%, while the pension obligations grew by $430 billion, a compound annual growth rate of roughly 10%." See also page 2, *Pension Tension*, Morgan Stanley (Aug. 27, 2004). "DB sponsors were lulled into complacency by inappropriate and opaque accounting rules, misleading advice from their actuaries causing unrealistic return and mortality assumptions, and mismatched funding of the liabilities, and the two decades of bull equity markets through the 1990s veiled true funding needs."



The most immediate threat to the pension insurance program stems from the airline industry. Just last month, the PBGC became statutory trustee for the remaining pension plans of US Airways, after assuming the pilots' plan in March 2003. The $3 billion total claim against the insurance program is the second largest in the history of the PBGC, after Bethlehem Steel at $3.7 billion.

In addition, United Airlines is now in its 27th month of bankruptcy and has argued in bankruptcy court that it must shed all four of its pension plans to successfully reorganize. The PBGC estimates that United's plans are underfunded by more than $8 billion, more than $6 billion of which would be guaranteed and a loss to the pension insurance program.

Apart from the significant financial impact to the fund, if United Airlines is able to emerge from bankruptcy free of its unfunded pension liability, serious questions arise as to whether this would create a domino effect with other so-called "legacy" carriers, similar to what we experienced in the steel industry. Indeed, several industry analysts have indicated that these remaining legacy carriers could not compete effectively in such a case and several airlines executives have publicly stated that they would feel competitive pressure to shift their pension liabilities onto the government if United is successful in doing so. Of course, these companies would first have to meet the statutory criteria for distress terminations of their pension obligations.

While the losses incurred by the pension insurance program to date have been heavily concentrated in the steel and airline industries, it is important to note that these two industries have not been the only source of claims, nor are they the only industries posing future risk of losses to the program.

The PBGC's best estimate of the total underfunding in plans sponsored by companies with below-investment-grade credit ratings and classified by the PBGC as "reasonably possible" of termination is $96 billion at the end of fiscal 2004, up from $35 billion just two years earlier. The current exposure spans a range of industries, from manufacturing, transportation and communications to utilities and wholesale and retail trade.[7] Some of the largest claims in the history of the pension insurance program involved companies in supposedly safe industries such as insurance ($529 million for the parent of Kemper Insurance) and technology ($324 million for Polaroid).

Reasonably Possible Exposure
(Dollars in Billions)

Principal Industry Categories	FY 2004	FY 2003
Manufacturing	$ 48.4	$ 39.5
Transportation, Communication & Utilities	30.5	32.9
Services & Other	7.9	2.5
Wholesale and Retail Trade	5.8	4.3
Agriculture, Mining & Construction	1.9	1.8
Finance, Insurance & Real Estate	1.2	1.1
Total	$95.7	$82.1

Some have argued that current pension problems are cyclical and will disappear on the assumption that equity returns and interest rates will revert to historical norms. Perhaps this will happen, perhaps not. The simple truth is that we cannot predict the future path of either equity values or interest rates. It is not reasonable public policy to base pension funding on the expectation that the unprecedented stock market gains of the 1990s will repeat themselves. Similarly, it is not reasonable public policy to base pension funding on the expectation that interest rates will increase dramatically.[8] The consensus forecast predicted that

[7] In a recent report, Credit Suisse First Boston finds that the auto component and auto industry groups have the most exposure to their defined benefit plans (even more so than airlines). The report notes that "these two industry groups stand out because, compared to others, the degree of their pension plan underfunding is significant relative to market capitalization." See page 60, The Magic of Pension Accounting, Part III, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005).

[8] See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005). "Unfortunately things are likely to get worse before they get better. . . As of the beginning of February, the Moody's AA long term corporate index was below 5.50% and 30-year Treasuries were below 4.5%."

long-term interest rates would have risen sharply by now, yet they remain near 40-year lows.[9] And, a recent analysis by the investment management firm PIMCO finds that the interest-rate exposure of defined benefit plans is at an all-time high, with more than 90 percent of the exposure unhedged.[10]

More importantly, while rising equity values and interest rates would certainly mitigate the substantial amount of current underfunding, this would not address the underlying structural flaws in the pension insurance system.

Structural Flaws in the Defined Benefit Pension System

The defined benefit pension system is beset with a series of structural flaws that undermine benefit security for workers and retirees and leave premium payers and taxpayers at risk of inheriting the unfunded pension promises of failed companies. Only if these flaws are addressed will safety and soundness be restored to defined benefit plans.

Weaknesses in Funding Rules

The first structural flaw is a set of funding rules that are needlessly complex and fail to ensure that pension plans are adequately funded. Simply stated, the current funding rules do not require sufficient pension contributions for those plans that are chronically underfunded. Rather than encouraging strong funding and dampening volatility as some have argued, aspects of current law such as smoothing and credit balances have been primary contributors to the substantial systemic underfunding we are experiencing. The unfortunate fact is that companies that have complied with all of the funding requirements of ERISA and the Internal Revenue Code still end up with plans that are less than 50 percent funded when they are terminated. Some of the problems with the funding rules include:

- The funding rules set funding targets too low. Employers are not subject to the deficit reduction contribution rules when a plan is funded at 90 percent of "current liability," a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. In addition, in some cases employers can stop making contributions entirely because of the "full funding limitation." As a result, some companies say they are fully

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[9] Long-term rates have declined in Japan and Europe – to 2.5 percent and 4.0 percent, respectively – two economies facing the same structural and demographic challenges as the United States. See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005).

[10] See page 1, *Defined Benefit Pension Plans' Interest Rate Exposure at Record High*, Seth Ruthen, PIMCO (Feb. 2005).

funded when in fact they are substantially underfunded.[11] Bethlehem Steel's plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. US Airways' pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. No wonder US Airways pilots were shocked to learn just how much of their promised benefits would be lost.

Bethlehem Steel

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities $4.3 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Ratio	78%	91%	99%	96%	86%	84%	NR
Was the company required to make a deficit reduction contribution?	Y	N	N	N	N	NR	NR
Was the company obligated to send out a participant notice?	Y	Y	N	N	N	N	N
Did the company pay a Variable Rate Premium?	$15 million	$17 million	N	N	N	N	N
Actual Contributions	$354 million	$32.3 million	$30.9 million	$ 8.1 million	$0	$0	$0
Debt Rating	B+	B+	BB-	BB-	B+	D	Withdrawn

[11] Generally, a plan's actuarial assumptions and methods can be chosen so that the plan can meet the "full-funding limitation" if its assets are at least 90 percent of current liability. Being at the full-funding limitation, however, is not the same as being "fully funded" for either current liability or termination liability. As a result, companies may say they are fully funded when in fact they are substantially underfunded. This weakness in the current funding rules is exacerbated by premium rules that exempt plans from paying the Variable Rate Premium (VRP) if they are at the full funding limit. As a result a plan can be substantially underfunded and still pay no VRP. Despite substantial underfunding, in 2003 only about 17 percent of participants were in plans that paid the VRP.

US Airways Pilots

Termination Benefit Liability Funded Ratio 33%

Unfunded Benefit Liabilities $2.5 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Ratio	97%	100%	91%	85%	104%	94%	NR
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N	NR
Was the company obligated to send out a participant notice?	N	N	N	N	N	N	N
Did the company pay a variable rate premium?	$4 million	N	N	N	$2 million	N	N
Actual Contributions	$112.3 million	$0	$45 million	$0	$0	$0	$0

- The funding rules allow contribution holidays even for seriously underfunded plans. Bethlehem Steel made no cash contributions to its plan for three years prior to termination, and US Airways made no cash contributions to its pilots' plan for four years before termination. One reason for contribution holidays is that companies build up a "credit balance" for contributions above the minimum required amount. They can then treat the credit balance as a payment of future required contributions, even if the assets in which the extra contributions were invested have lost much of their value. Indeed, some companies have avoided making cash contributions for several years through the use of credit balances, heedlessly ignoring the substantial contributions that may be required when the balances are used up.

- The funding rules rely on the actuarial value of plan assets to smooth plan contribution requirements. However, the actuarial value may differ significantly from the fair market value. Actuarial value is determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years. The use of a smoothed actuarial value of assets distorts the funded status of a plan.[12] Masking current market conditions is neither a good nor a necessary way to avoid volatility in funding contributions. Using fair market value of assets would provide a more

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[12] Page 72, *The Magic of Pension Accounting, Part III*, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 7, 2005). "Volatility is not necessarily a bad thing, unless it's hidden. . . . Volatility is a fact of doing business; financial statements that don't reflect that volatility are misleading."

accurate view of a plan's funded status. I would also note that the smoothing mechanisms in ERISA and financial accounting standards are anomalies - airlines are not allowed to smooth fuel costs; auto companies are not allowed to smooth steel prices; global financial firms are not allowed to smooth currency fluctuations.

- The funding rules do not reflect the risk of loss to participants and premium payers. The same funding rules apply regardless of a company's financial health, but a PBGC analysis found that nearly 90 percent of the companies representing large claims against the insurance system had junk-bond credit ratings for 10 years prior to termination.

- The funding rules set maximum deductible contributions too low. As a result, it can be difficult for companies to build up an adequate surplus in good economic times to provide a cushion for bad times. (However, this was not a significant issue in the 1990s—a PBGC analysis found that 70 percent of plan sponsors contributed less than the maximum deductible amount.)

Moral Hazard
A second structural flaw is what economists refer to as "moral hazard." A properly designed insurance system has various mechanisms for encouraging responsible behavior that will lessen the likelihood of incurring a loss and discouraging risky behavior that heightens the prospects of claims. That is why banks have risk-based capital standards, why drivers with poor driving records face higher premiums, why smokers pay more for life insurance than non-smokers, and why homeowners with smoke detectors get lower rates than those without.

However, a poorly designed system can be gamed. A weak company will have incentives to make generous but unfunded pension promises rather than increase wages. Plan sponsors must not make pension promises that they cannot or will not keep. For example, under current law benefits can be increased as long as the plan is at least 60 percent funded. In too many cases, management and workers in financially troubled companies may agree to increase pensions in lieu of larger wage increases. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years.

Or, labor may choose to bargain for wages or other benefits rather than for full funding of a plan because of the federal backstop.[13] If the company recovers, it may be able to afford the increased benefits. If not, the costs of the insured

[13] See page 3, *The Most Glorious Story of Failure in the Business*, James A. Wooten, 49 Buffalo Law Rev. 683 (Spring/Summer 2001). "Termination insurance would shift default risk away from union members and make it unnecessary for the UAW to bargain for full funding."

portion of the increased benefits are shifted to other companies through the insurance fund. Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders and much of the downside risk being shifted to other premium payers.

Unfortunately, the pension insurance program lacks basic checks and balances. PBGC provides mandatory insurance of catastrophic risk. Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance underwriting methods. Plan sponsors face no penalties regardless of the risk they impose on the system. As a result, there has been a tremendous amount of cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

Consider: Bethlehem Steel presented a claim of $3.7 billion after having paid roughly $60 million in premiums over the 10-year period 1994 to 2003, despite the fact that the company was a deteriorating credit risk and its plans were substantially underfunded for several years prior to the time the PBGC had to step in. Similarly, while United's credit rating has been junk bond status and its pensions underfunded by more than $5 billion on a termination basis since at least 2000, it has paid just $75 million in premiums to the insurance program over the 10-year period 1995 to 2004. Yet the termination of United's plans would result in a loss to the fund of more than $6 billion.

PBGC cannot control its revenues and cannot control most of its expenses. Congress sets PBGC's premiums, ERISA mandates mandatory coverage for all defined benefit plans whether they pay premiums or not, and companies sponsoring insured pension plans can transfer their unfunded liability to PBGC as long as they meet the statutory criteria.

Not surprisingly, PBGC's premiums have not kept pace with the growth in claims or pension underfunding. The flat rate premium has not been increased in 14 years. And as long as plans are at the "full funding limit," which generally means 90 percent of current liability, they do not have to pay the variable-rate premium. That is why some of the companies that saddled the insurance fund with its largest claims ever paid no variable-rate premium for years prior to termination. In fact, less than 20 percent of participants are in plans that pay a VRP.

Transparency

A third flaw is the lack of information available to stakeholders in the system. The funding and disclosure rules seem intended to obfuscate economic reality. That is certainly their effect—to shield relevant information regarding the

funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory, and often misleading information required under ERISA. For example, the principal governmental source of information about the 30,000 private sector single-employer defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC receives the complete documents the information is typically two and a half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

The PBGC does receive more timely information regarding a limited number of underfunded plans that pose the greatest threat to the system, but the statute requires that this information not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan, changes in assets and liabilities, and the amount that participants would stand to lose at termination are vitally important to participants. Investors in companies that sponsor the plans also need relevant and timely information about the funded status of its pensions on a firm's earnings capacity and capital structure. While recent accounting changes are a step in the right direction, more can and should be done to provide better information to regulatory bodies and the other stakeholders in the defined benefit system.

Congress added new requirements in 1994 expanding disclosure to participants in certain limited circumstances, but our experience tells us these disclosures are not adequate. The notices to participants do not provide sufficient funding information to inform workers of the consequences of plan termination. Currently, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information provided does not reflect what the underfunding likely would be if the plan terminated. Workers in many of the plans we trustee are surprised when they learn that their plans are underfunded. They are also surprised to find that PBGC's guarantee does not cover certain benefits, including certain early retirement benefits.

Finally, the Corporation's ability to protect the interests of plan participants and premium payers is extremely limited, especially when a plan sponsor enters bankruptcy. Currently, the agency has few tools at its disposal other than plan termination. While PBGC has successfully used the threat of plan termination to prevent instances of abuse of the pension insurance program, it is a very blunt instrument. Plan termination should be a last resort, as it means that participants will no longer accrue benefits (and may lose benefits that have been promised) and the insurance programs takes on losses that might have been avoidable.

Conclusion

Companies that sponsor pension plans have a responsibility to live up to the promises they have made to their workers and retirees. Yet under current law, financially troubled companies have shortchanged their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk. As United Airlines noted in a recent bankruptcy court filing, "the Company has done everything required by law"[14] to fund its pension plans, which are underfunded by more than $8 billion.

That, Mr. Chairman, is precisely why the rules governing defined benefit plans are in need of reform. At stake is the viability of one of the principal means of predictable retirement income for millions of Americans. The time to act is now. Thank you for inviting me to testify. I will be pleased to answer any questions.

[14] Page 26, United Air Lines' Informational Brief Regarding Its Pension Plans, in the US Bankruptcy Court for the Northern District of Illinois, Eastern Division (Sept. 23, 2004).

RESPONSE TO A QUESTION FROM SENATOR BAUCUS

Question: Assuming the administration's funding proposal were adopted, but PBGC was not given authority to set the variable rate, what rate per $1,000 would you recommend that Congress adopt?

Answer: The reason the administration proposes that the PBGC board of directors set the variable-rate premium level based on market conditions and the financial condition of the insurance fund (as is the case with the FDIC) is that a single statutory rate will inevitably be too low or too high. The last time that Congress adjusted the variable-rate premium was in 1994. While the rate may have been appropriate at that point in time, it has proven to be substantially less than needed to cover actual losses and future expected claims. The role of risk-based premiums under the administration's proposal is to provide the pension insurance program with the amount of total premium revenue necessary to meet expected future claims and to retire the program's deficit over a reasonable time period. The proposal calls for the premium rate per dollar of under-funding to be reviewed and revised periodically by the PBGC board consistent with meeting these goals. The risk-based rate adjustments would be computed based on forecasts of expected claims and of the future financial condition of the insurance program.

The budget numbers for the administration's funding proposal reflect a risk-based premium rate of $8–$9 per $1,000 of under-funding assuming that all under-funding is assessed, that the flat-rate reforms are enacted, and that premium revenues are to cover expected future claims and to amortize the $23-billion deficit over 10 years.

RESPONSES TO QUESTIONS SUBMITTED BY SENATOR BAUCUS ON BEHALF OF SENATOR KEN SALAZAR

Question: Since United Airlines announced its intention to terminate the defined benefit pension plans of its employees, thousands of hard-working pilots, flight attendants, and machinists who were promised future pension benefits have discovered that the pensions they have earned may be lost because they are much larger than benefits guaranteed under our government's pension insurance program. This news has caused great anxiety and apprehension among Colorado households and other households that planned on the pension benefits they were promised from United Airlines.

You took action to terminate the United Airline's pilot's plan. At what point in the process do you begin communicating directly with the beneficiaries?

As the termination progresses, what steps will you take to inform United pension beneficiaries of the status of their pension benefits under the government program and to ensure a smooth transition of benefits for these individuals?

Answer: Termination of under-funded pension plans can have harsh consequences for workers and retirees. When plans terminate, workers' and retirees' expectations of a secure future may be shattered because, by law, not all benefits promised under a plan are guaranteed. The PBGC tries to minimize participants' anxieties by making the transition to the PBGC insurance program as smooth and transparent as possible.

In the case of the United Airline's pilots' plan, PBGC trusteeship of the plan is awaiting court approval or the company's execution of a trusteeship agreement. Although the PBGC has been engaged in discussions with the company and unions for many months, it has no access to participant records until after it takes over as trustee. As soon as PBGC trusteeship occurs, we will send a letter to all participants informing them that PBGC has become responsible for their plan. The letter will explain that retirees will continue receiving benefits without interruption while the plan's records are reviewed, and that both retirees and other participants who apply for retirement in the near future will receive estimated benefits payable to them under law. Prior to trusteeship by PBGC, participants may obtain general information about what happens when PBGC takes over a plan by calling the PBGC's customer information center or visiting the PBGC's website.

Within a few months of trusteeship, PBGC will have calculated estimated benefits for retirees whose benefits will be reduced. PBGC will send retirees a statement of their estimated benefit amounts and will reduce monthly payments to estimated amounts a month or so later. At about the same time, PBGC will hold participant meetings in cities with the largest participant populations to discuss the plan's benefit provisions, PBGC's administration of the plan, and benefit guarantees and limitations. At these meetings, retirees have an opportunity to ask specific questions about their estimated benefit statements. (In 2004, PBGC held 195 meetings that were attended by 23,743 participants.)

Vested participants who are not yet eligible to retire may request an estimate of their benefits at any time after trusteeship, but final benefit statements may take up to 3 years after trusteeship. Prior to issuing final benefit statements, PBGC collects and audits plan and participant records, reconstructs missing records, calculates each participant's benefit and the effect of PBGC's maximum guarantees and other limitations, obtains any recoveries from the company, and values and allocates plan assets and recoveries to benefits.

PBGC's ability to make timely benefit determinations depends in large measure on the quality of the records maintained by the sponsor, and, unfortunately, we've encountered situations in the past where record maintenance has been poor.

If a participant wishes to retire before final benefit amounts have been determined, the PBGC will pay an estimated benefit. Underpayments and overpayments will be corrected after final benefit calculations are completed. Participants are entitled to appeal the PBGC's final benefit determinations.

Question: The Federal Aviation Administration requires commercial pilots to retire at age 60. However, the PBGC statute penalizes employees who retire before age 65 by decreasing the maximum pension benefit amount guaranteed. The consequences of these conflicting laws are grave for many United Airlines pilots. Not only will they not receive the full pension benefits promised by United Airlines, but they will be penalized further by the government-guaranteed pension they do receive—for obeying the law and retiring at age 60.

Do you believe that the interaction of these two laws is consistent with the spirit and mission of the PBGC?

Are you aware of any other job categories that are similarly impacted by the reduction for retirement before age 65?

Answer: We do not believe that the interaction of these two laws is inconsistent with the spirit and mission of the PBGC. The maximum guarantee limit established in ERISA is reduced where a retiree is younger than 65 when his or her plan terminates, because a benefit commencing at an earlier age is paid over a longer period of time than the same benefit amount commencing at 65. The reduction applies to *any* retiree who is younger than 65 at termination, not just to pilots. Indeed, thousands of steelworkers and other participants who retired in their 50s or early 60s have had their benefits reduced because of this rule. Generally, pilots may not fly commercially after age 60. However, they can—and often do—continue working after age 60 in other capacities. Participants whose benefits would be cut by the maximum guarantee because of age and who have not yet started their pensions when the plan terminates may choose to wait until age 65 to begin payments. We also note that Social Security operates in the same way as the PBGC maximum guarantee limit: a person who commences his or her Social Security benefit at age 62 receives a lower benefit than if he or she waited until 65 or a later age. This

age reduction in Social Security benefits is made for the same reasons as the age reduction in PBGC's maximum benefit.

RESPONSE TO A QUESTION FROM SENATOR HATCH

Question: Mr. Belt, in your testimony you stated that in the worst case, PBGC's deficit could grow so large that the premium increases necessary to close the gap would become unbearable to responsible premium payers. You hinted that a taxpayer bailout might then become necessary. At what point does the PBGC deficit approach this critical stage? Are we close to it now? Could we get into a situation where stronger companies now paying premiums become concerned enough to freeze or terminate their own defined benefit plans, not because they are worried about being able to keep funding them, but because they are concerned about being stuck with unfair premiums brought on by so many other companies failing?

You mentioned that PBGC's first statutory mandate is to encourage the continuation and maintenance of voluntary private pension plans. It seems to me that the current problems facing defined benefit plans, if they continue to worsen, could deteriorate into an outright crisis. Add to this the problems that hybrid pension plans are facing, and the outlook for DB plans looks quite bleak. I have two questions. First, do you think the defined benefit pension plan system is in crisis, and, second, what are the critical steps Congress must take this year to prevent a taxpayer bailout and/or the end of the DB system?

Answer: Enacting the administration's pension reform proposals is a critical step to revitalize the DB system and to restore the pension insurance program to financial health. The administration believes that the companies that make promises to their employees should fund those promises. Inevitably, there will be incidences of default, and losses will occur. One of the objectives of the administration's proposal is to ensure that when plans do terminate, they are not substantially under-funded. The problem is that the current funding rules don't work and have allowed companies to terminate plans with large, in some cases, multi-billion dollar deficits. As a result, PBGC's deficit has grown to more than $23 billion, and the insurance program is facing tens of billions of dollars of additional exposure. Under current law, the PBGC has insufficient resources to meet its commitment to participants over the longer term, and the financial integrity of the insurance program is likely to be further impaired without comprehensive reform of the funding rules.

With respect to your question about the willingness of stronger companies to continue to maintain their defined benefit plans if PBGC's deficit grows, the administration's proposals would provide the necessary reforms to strengthen the system so that strong companies would not exit. The proposed premium structure would make it possible for PBGC's board to increase premium revenues enough to fund expected future claims and retire the existing single-employer program deficit over a reasonable period of time. Premiums would more fairly reflect the risk that each plan poses to the system than under the current structure. The proposed structure would eliminate unfair exemptions from risk-based premiums, and would set risk-based premiums based on a more accurate measurement of plan under-funding that reflects the financial health of the plan sponsor.

The term "crisis" is an oft-overused one, but there clearly are significant challenges facing the defined benefit system and insurance program. In addition to the premium reforms, other structural reforms are needed. First, the administration's proposals for basic funding reforms are essential to ensuring that pension plans are adequately funded and benefit promises are kept. The administration's proposal would use more accurate measures of assets and liabilities, and base funding targets on the plan sponsor's financial health. It would eliminate contribution holidays that arise from current credit balances and allow plan sponsors to make additional deductible contributions during good economic times. It would also improve disclosure to workers, investors and regulators, and reform the pension insurance premium structure. Second, the issues surrounding cash balance plans must be addressed in order to provide stability and certainty to employers.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: I am very concerned with some of the administration's suggestions for limiting benefit increases and accruals. It seems to me that these changes would punish workers in cases where company management fails to invest enough money in the pension plan.

The administration has claimed that these benefit restrictions would prompt workers to put pressure on employers to better fund pension plans. However, it is not clear to me how workers could effectively stop employers from under-funding plans.

I would like to hear how you expect workers to protect themselves, and please specifically address how they could do so *between* contract negotiations as their benefits are being cut.

I would also like to know what would prevent an employer from purposely under-funding the pension plan in order to deprive workers of hard-won pension benefit increases?

Answer: The administration believes that we must ensure that companies make only benefit promises they can afford, and keep the promises already made by appropriately funding their pension plans. When companies are unable to keep their pension promises, the losses are shifted to the pension insurance system and to workers. It is these empty promises that harm workers by putting their retirement security at risk. The new stronger minimum funding rules combined with the proposed limitations will prevent companies from making hollow promises.

The stronger minimum funding rules will prevent employers from purposely under-funding their pension plans. Companies will be required to fund their plans up to a meaningful funding target. Companies that fall below the minimum funding target will be required to fund up to the target within a reasonable period of time. A plan sponsor that is operating outside of bankruptcy cannot ignore its funding obligations without serious consequences. There are significant enforcement measures available to the IRS and the PBGC to prevent firms from ignoring funding obligations.

The proposed benefit limitations will apply only when a plan's funded status falls below acceptable levels. The limit on benefit increases for certain under-funded plans will prevent companies from promising additional benefits unless promises already made to workers are adequately funded. The limit on accruals will apply only for plans with severe funding shortfalls or sponsors in bankruptcy with under-funded plans. The limitations will not affect benefits already earned. Rather than deprive workers of hard-won pension benefit increases, we believe that these proposals create a strong incentive for employers to adequately fund their plans—making it more likely that workers' retirement expectations will be met. Our proposal takes into account existing collective bargaining agreements by not applying these benefit limitations until the earlier of the end of the contract term or 2009.

Plans that become subject to any of the benefit limitations will be required to notify affected workers, making them aware that deteriorating funding is threatening their benefits. Workers need this information so that they can have realistic expectations about their company's ability to fund pension promises. We also believe that in some instances, companies will improve the funding of their plans in order to avoid notifying workers and thereby creating worker dissatisfaction.

Question: I am very concerned that the administration has made no proposal to address the pension crisis in the airline industry. A considerable amount of the deficit facing the PBGC is expected to derive from failing airline pension plans. Yet the administration has proposed no remedies specific to that industry that would help airlines maintain their plans.

Some airlines have asked Congress to consider relief that would allow them to essentially restructure their pension plans. By giving the companies a longer time period to pay off debt and perhaps limiting the PBGC's exposure to increases in pension liabilities, airlines may be able to save their pension plans.

What industry-specific relief is the administration willing to consider to protect the pension benefits of airline employees and help the companies maintain promises they made to their workers?

Answer: We understand the financial difficulties the airlines are facing. Congress and the administration have provided assistance to the airlines in the form of grants, loan guarantees, and short-term funding relief when such assistance was determined to be appropriate.

The administration's pension reform proposal would strengthen the funding rules to improve the health of the entire defined benefit pension system. This is particularly important for those under-funded plans that pose the greatest risk of terminating. Neither the defined benefit system nor the pension insurance system is designed to provide or capable of providing targeted relief to specific industries. It is designed to insure benefits for participants in plans that fail.

Relaxing the funding rules for a specific industry would set a dangerous precedent for the pension insurance program. We do not believe that the interests of participants, other premium payers, or the taxpayer are best served by allowing companies to effectively borrow from their employees and the insurance fund to meet their financial obligations.

I would also emphasize that the majority of losses incurred by the PBGC to date have been in industries other than airlines and that the majority of the insurance fund exposure to "reasonably possible" claims is in other industry sectors. So, the

financial pressures on the pension insurance program are not unique to the airline industry.

Current law allows plan sponsors to obtain funding waivers if they are experiencing temporary substantial business hardship. The IRS can, in consultation with the PBGC, and often does, impose conditions on obtaining a waiver that protect the interests of participants and the pension insurance program.

Question: I appreciate the difficulty we are facing in trying to shore up the defined benefit pension plan system. On the one hand, we want to better protect workers by making sure that employers are adequately funding their pension promises. On the other hand, we want to encourage employers to continue to provide defined benefit pensions that protect workers and retirees from the risks associated with the stock market.

I am very concerned that the administration's proposal focuses just on addressing the deficit faced by the PBGC. Many aspects of this proposal would increase funding to the PBGC, but actually make it much harder for employers to maintain these plans.

For example, the yield curve proposed by the administration would be much more volatile and difficult for employers to predict and plan for. The yield curve also substantially increases the liability calculations for industries that have older workers. Even healthy plans would see substantial premium increases under the administration's reforms.

I am concerned that these are shortsighted fixes to the PBGC's funding problems. As defined benefit plans become more and more expensive for employers, many companies will simply shift away from offering such pensions. As healthy plans voluntarily terminate, the funding problems in the system increase, creating a vicious cycle.

How does the administration propose to encourage companies to continue to offer defined benefit plans?

Answer: We would respectfully disagree that the administration's proposal focuses just on improving the pension insurance program deficit or that it would or should cause employers to abandon their pension plans. We believe the proposal appropriately balances competing considerations. The objective is to ensure that plan sponsors honor the promises they have made, and the proposal requires companies to make up their funding gap over a reasonable period of time. At the same time, the administration's proposal provides additional flexibility for plan sponsors and provides numerous incentives for them to maintain and prudently fund the plans they sponsor.

For example, companies will be able to make much larger tax-deductible contributions to their plans during good economic times than under current law. Companies that contribute more than the minimum requirement would effectively shorten the amortization period. They would be able to reduce the amount of risk-based premium that would have to be paid. And companies would likely benefit from improved credit ratings if they reduced their unfunded pension liability, thus lowering their cost of capital.

We also do not agree that the administration's proposal would lead to greater volatility and make it more difficult for companies to predict their funding requirements. The risk and volatility in the pension plan is a function of the business decisions made by the company. Current law simply masks that volatility and allows companies to shift the risks to third parties. It is because of current-law features like smoothing and credit balances that plans sometimes are so under-funded when they terminate. Hiding the problem doesn't make it go away. There are numerous ways under the administration's proposal in which companies can minimize risk and volatility and make funding more predictable.

The administration also believes that Congress should act promptly to clarify the legal status of cash balance and other hybrid pension plans. The only new defined benefit plans created in recent years have been alternative benefit structures, such as cash balance or pension equity plans that are designed to meet the needs of a younger, more mobile workforce. Unfortunately, as a result of a single Federal court decision, the legal status of these types of plans is in question.*

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* *Cooper* v. *IBM Personal Pension Plan,* 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle* v. *ARINC, Inc.,* 222 F.R.D. 88 (D. Md. 2004); *Eaton* v. *Onan Corp.,* 117 F. Supp. 2d 812 (S.D. Ind. 2000).

RESPONSES TO QUESTIONS FROM SENATOR SMITH

PAYOUT OPTIONS

Question: So many of the demographic figures I have seen lately speak to the fact that more and more of the responsibility for accumulating retirement savings is shifting to the individual. Half of American workers get help from their employers in the form of employer-provided savings, and half of our workers must do it on their own. Of course we're here discussing some of the ways to achieve further security for those who do have such access to traditional pensions and what can be done to make them more secure.

I have actually introduced legislation that would give the same guaranteed payout streams as traditional pensions to those who do not have access to such employer-provided plans. What the legislation provides is an incentive to consider the "delayed gratification" of an annuitized payout you can't outlive when compared against the "instant gratification" of receiving a simple lump sum.

The reason why I raise this issue is that even the defined benefit pension plans we are discussing today are trending increasingly toward paying lump sums at retirement; in particular, cash balance plans. For those of us concerned that retirees need to consider taking a guaranteed payout stream rather than just a lump sum, what can you tell me about your plans that will create some payout options for retirees?

Answer: The administration's funding proposal will strengthen and preserve the defined benefit system. Preserving the system will enable more workers to have the option of taking their pension distributions in the form of annuities. The administration's proposal also eliminates an inappropriate incentive for participants to take lump-sum distributions.

Under current law, the use of an inappropriately low discount rate for determining the value of lump sums creates an incentive for participants to choose lump sums. Under our proposal, the yield curve would be used to calculate minimum lump sums, which will eliminate this distortion that can bias a participant's payout decision toward lump sums. 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.

MULTIEMPLOYER PLANS

Question: It is my understanding that the administration is not planning on taking any action on multiemployer plans in the near future. However, there is a crisis brewing among the multiemployer plans as well. Some very large plans are close to having to go into "reorganization," and many retirees in my State of Oregon will be impacted. Does the administration plan on reporting to us on the risk that the multiemployer system would have to assume if some of these multiemployer plans become insolvent?

Answer: The administration recognizes that changes in the multiemployer funding rules are necessary. However, we focused on single-employer plans first because the problems facing single-employer plans are more immediate and acute. Also, due to the unique nature of multiemployer plans, not all elements of the single-employer proposal could be immediately applied to multiemployer plans. We believe it is vitally important that Congress enact legislation to protect the retirement security of workers in these single-employer pension plans. At the same time, however, we must remember that there are millions of Americans who are covered by multiemployer pension plans, and that their retirement security is equally important. We should work together in a bipartisan fashion to ensure that multiemployer plans are strengthened.

The multiemployer insurance program covers about 9.8 million workers and retirees in about 1,600 plans. The program has only one source of funds, an annual premium payment of $2.60 per participant that generates about $24 million of income per year.

The PBGC insurance comes into play when a multiemployer plan becomes insolvent—that is, when the plan does not have enough assets to pay benefits that fall under the statutory limit, which was originally set at less than $6,600 per year for a retiree with 30 years of service. In 2001, Congress amended the law to double the limit—to $12,870 per year—but did not increase the premium. Between 1980 and 2000, relatively few multiemployer plans failed; the agency paid out $167 million to some 33 plans.

Recently, however, more plans have failed. In its 2004 Annual Report, PBGC estimates that financial assistance payments to multiemployer plans denoted as "probables" will reach $30 million in 2005, $90 million in 2006, and $100 million per year for at least a decade thereafter. In addition, it is "reasonably possible" that other multiemployer plans will require future financial assistance in the amount of $108 million in present-value terms.

The multiemployer program ran surpluses for over 20 years until it recorded its first deficit of $261 million in FY 2003. The multiemployer program reported a deficit of $236 million in FY 2004. This is in contrast to the $23.3-billion deficit in the single-employer program.

In the 2004 Annual Report, PBGC estimated that, as of September 30, 2004, the total under-funding in insured multiemployer plans is more than $150 billion, compared to a 2003 estimate of more than $100 billion.

The Government Accountability Office recently completed a study that concluded that multiemployer plans face long-term challenges, and we agree with this assessment. Because multiemployer plans are creatures of collective bargaining, the dwindling percentage of union coverage in private-sector employment has halted growth. In addition, a substantial number of plans are concentrated in industries such as trucking and retail foods, where employers and unions will encounter increased cost competition from new competitors.

The PBGC is required by law to review the multiemployer plan insurance program every 5 years to assess, in a report to Congress, whether changes in the current guaranteed benefit can be supported by the existing premium structure. The PBGC expects to complete work on the next 5-year report in late 2005.

PBGC LIABILITY

Question: In measuring its liability, the PBGC has historically used an interest rate that is well below market rates. What would the PBGC's deficit be using the corporate bond interest rate that Congress enacted last year? And, what would the PBGC deficit be using the administration's yield curve methodology?

The administration's proposals would require some employers to make much larger pension contributions starting right away. How much modeling has the administration done to determine how many companies would not be able to meet those sudden increases in cash flow demand? How certain are you that we will not see more bankruptcies as a direct result of this proposal and that you will only be turning some of those "probables" into "definite problems" for the PBGC?

Answer: Actually, the PBGC does use market prices for valuing its liabilities both on its financial statements and for our claims in bankruptcy. The PBGC conducts surveys of the prices charged by private-sector insurance companies to write group annuity contracts and derives an interest factor from those prices that, with PBGC's mortality table, will match the prices. The rationale for this approach is that it maintains a "level playing field" between plans that terminate with PBGC and plans that terminate in the private sector. Put another way, if a plan sponsor determined to terminate its plan (which would have to be fully funded) and annuitize the benefits to its employees, a private-sector annuity provider would value those liabilities the same way that PBGC does.

Using an interest factor based on prices for annuities charged by private-sector insurance companies, the PBGC's single-employer deficit was $23.3 billion. If PBGC had valued liabilities using 100 percent of the spot corporate bond rate that is currently used for determining PBGC premiums, the deficit would have been about $18 billion. (Pursuant to legislation enacted by Congress last year, the corporate bond rate is used differently for different purposes: (1) a 4-year weighted average is used to determine plan funding, and (2) a spot rate is used to determine PBGC premiums.) If, instead, the PBGC had valued liabilities using the administration's yield curve methodology, the deficit would have been about $19 billion. Both estimates assume that PBGC would continue to include in liability estimates the present value of its own future expenses as it does under current procedures. It is also important to note that while the single-employer deficit would be lower using these approaches, there still would have been a dramatic swing in the corporation's financial position from a surplus to a very large deficit over the past 3 years.

We have modeled the proposal in the aggregate for the entire defined benefit system. The data indicate that the funded status of both healthy ongoing and at-risk plans improves over time under the administration's proposal, which is the core objective of reform. We should not lose sight of the fact that the current funding rules don't work and have allowed the huge funding gap to develop and grow. Absent the kind of fundamental changes in the administration's proposal, there is a significant risk that the level of under-funding in terminated plans will get much larger. We

do not have the information needed to evaluate the financial impact of the proposal on particular plan sponsors. We believe that the funding rules should apply to all plan sponsors, and it would be inappropriate to create special rules for a particular industry or company.

Various underlying business factors apart from pension funding lead to corporate bankruptcies. That will continue to be the case in the future. If we make no changes in the funding rules or further relax them, plans of bankrupt firms will be more under-funded, participants will lose more benefits, and the taxpayer will be put at greater risk.

It is in everyone's best interest to keep well-funded plans in the defined benefit system. At the same time, as we have seen, plan under-funding is destabilizing to the system. These concerns are fairly and effectively addressed by the administration's proposal, which would require funding of benefit promises over a reasonable period of time.

PREPARED STATEMENT OF ANN COMBS

INTRODUCTORY REMARKS

Good afternoon, Chairman Grassley, Ranking Member Baucus, and members of the committee. Thank you for inviting me to discuss the administration's proposal to reform and strengthen the single-employer defined benefit pension system.

The Bush administration believes that the pension promises companies have made to their workers and retirees must be kept. Single-employer, private-sector defined benefit pension plans cover 16 percent of the Nation's private workforce, or about 34 million Americans. The consequences of not honoring pension commitments are unacceptable—the retirement security of millions of current and future retirees is put at risk.

However, the current system does not ensure that pension plans are adequately funded. As a result, pension promises are too often broken.

Termination of plans without sufficient assets to pay promised benefits has a very real human cost. Many workers' and retirees' expectations are shattered, and, after a lifetime of work, they must change their retirement plans to reflect harsh, new realities. Underfunded plan terminations are also placing an increasing strain on the pension guaranty system.

Increased claims from terminations of significantly under-funded pension plans have resulted in a record deficit in the single-employer fund of the PBGC. For the fiscal year ending September 30, 2004, the PBGC reported a record deficit of $23.3 billion in that fund. The increasing PBGC deficit and high levels of plan under-funding are themselves a cause for concern. More importantly, they are symptomatic of serious structural problems in the private defined benefit system.

It is important to strengthen the financial health of the defined benefit plan system now. If significantly under-funded pension plans continue to terminate, not only will some workers lose benefits, but other plan sponsors, including those that are healthy and have funded their plans in a responsible manner, will be called on to pay far higher PBGC premiums. Under-funding in the pension system must be corrected now to protect worker benefits and to ensure taxpayers are not put at risk of being called on to pay for broken promises.

The administration has developed a reform package to improve pension security for workers and retirees, stabilize the defined benefit system, and avoid a taxpayer bailout of PBGC. The President's proposal is based on three main elements.

First, the funding rules must be reformed to ensure that plan sponsors adequately fund their plans and keep their pension promises. The current system is ineffective and needlessly complex. The rules fail to ensure that many pension plans are and remain adequately funded.

Second, disclosure to workers, investors and regulators about pension plan status must be improved. Workers need to have good information about the funding status of their pension plans to make informed decisions about their retirement needs and financial futures. Too often in recent years, participants have mistakenly believed that their pension plans were well-funded, only to receive a rude shock when the plan is terminated. Regulators and investors also require more timely and accurate information about the financial status of pension plans than is provided under current law.

Third, premium rates must be revised to more accurately reflect the risk of a plan defaulting on its promises and to help restore the PBGC to financial health. The current premium structure encourages irresponsible behavior by not reflecting a plan's true level of risk.

The proposal would strengthen the funding rules and defined benefit system, so that the Nation's workers and retirees can be confident of the secure retirement they have worked for all their lives. I will now discuss the key provisions for each element of the President's proposal and the reasons these provisions are needed to protect the pensions of the 34 million Americans who are relying on the single-employer defined benefit pension promises made by their employers.

REFORMING THE FUNDING RULES

The funding rules are complicated and ineffective

Current funding rules do not establish accurate funding targets, and the lack of adequate consequences for under-funding a plan provides insufficient incentive for plans to become well-funded. In addition, the funding rules fail to take into account the risk that a plan sponsor will fail.

Weaknesses in the current rules include, for example, multiple and inaccurate asset and liability measures and discount rates, smoothing mechanisms, credit balances that allow funding holidays to continue even as funding levels deteriorate, excessive discretion over actuarial assumptions, and varying and excessively lengthy amortization periods. As a result, companies can say they are fully funded when in fact they are substantially under-funded. Together these weaknesses allow companies to avoid making contributions when they are substantially under-funded. And in some circumstances, they actually prevent companies that want to increase funding of their pension plans from making additional contributions during good economic times.

These weaknesses contribute to the ability to manipulate funding targets, which is of particular concern given the fact that they are set too low. There is no uniformity in liability measures under current law. In some cases, employers can stop making contributions when a plan is funded at 90 percent of "current liability." But current liability is not an accurate measure of pension funding requirements; even 100 percent of current liability is often far less than what will be owed if a plan is terminated. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants in the event of termination.

Why is current liability such a poor measure of true pension costs? One reason is that the interest rate used in determining current liability can be selected from an interest rate corridor that is based on an average of interest rates over the prior 48 months. As a result, during periods of rapidly changing interest rates, the current liability interest rate may bear little relationship to economic reality and misstate the risks to plan participants. Even if the current liability interest rate reflected current market conditions, it would produce an inaccurate measure of the plan's true liability because it is based on a long-term interest rate and fails to take into account the actual timing of when benefit payments will be due under the plan. That timing often is considerably sooner, especially for plans with a large number of older participants near retirement age.

Current liability also fails to account for the risk of plan termination. This is important because terminating plans incur additional costs not reflected in current liability. For example, when plans terminate, participants are more likely to draw benefits early and elect lump sums. Terminating plans must purchase insurance annuities at prices that reflect market interest rates and administrative expenses. These factors combine to escalate costs above those reflected in current liability, often by large amounts. While it is not necessary for all plans to fund to such a standard, in the case of a plan with a substantial risk of terminating, the pension funding target should take into account the additional costs of terminating the plan.

Another weakness in the funding rules is their reliance on the so-called "actuarial value" of plan assets. The actuarial value of plan assets may differ from the fair market value of plan assets. It may be determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years. The use of a smoothed actuarial value of assets distorts the funded status of the plan. Using fair market value for purposes of the funding rules would give a clearer and more accurate picture of a plan's ability to pay promised benefits.

As an example of how all of this can affect workers and retirees, the U.S. Airways pilots' plan was 94-percent funded on a current liability basis, but the plan was only 33-percent funded on a termination basis, with a $1.5 billion shortfall. After believing their pensions were substantially secure, U.S. Airways pilots were shocked to learn how much of their promised benefits would be lost. Bethlehem Steel's plan was 84-percent funded on a current liability basis, but the plan turned out to be only 45-percent funded on a termination basis, with a total shortfall of $4.3 billion.

The Bush administration's proposal

The current funding rules must be strengthened to ensure that accrued benefits are adequately funded. This is particularly important for those plans at the greatest risk of terminating. The administration's plan will bring simplicity, accuracy, stability, and flexibility to the funding rules, encouraging employers to fully fund their plans and ensuring that benefit promises are kept.

Under the President's proposal, the multiple sets of funding rules applicable to single-employer defined benefit plans would be replaced with a single set of rules. The rules would provide, for each plan, a single funding target that is based on meaningful, accurate measures of its liabilities that reflect the financial health of the employer and use fair market values of assets. Funding shortfalls would be amortized and paid over 7 years. Plan sponsors would have the opportunity to make additional, tax-deductible contributions in good years, even when the plan's assets are substantially above its funding target. In addition to the changes to the funding rules, new limits would be placed on unfunded benefit promises, reporting and disclosure of funding information would be improved, and PBGC premiums would be reformed to more fully reflect the risks and costs to the insurance program.

Funding targets will depend on the plan sponsor's financial health

Pension liability computations should reflect the true present value of accrued future benefits—this is a key component of accuracy. Workers and retirees are interested in the present value of liabilities so that they can determine whether their plans and promised benefits are adequately funded. Plan sponsors and investors are interested in the present value of liabilities in order to determine the demands pension liabilities will place on the company's cash flows.

The administration's proposal provides a single conceptual measure of liabilities based on benefits earned to date. Assumptions are modified as needed to reflect the financial health of the plan sponsor and the risk of termination posed by the plan. A plan's funding target would be the plan's ongoing, or alternatively, its at-risk liability, depending on the sponsor's financial health.

For a plan sponsor that is healthy, the funding target would be the plan's ongoing liability. The plan sponsor is considered financially healthy if any member of the plan sponsor's control group has senior unsecured debt rated as being investment grade (Baa or better). If a plan sponsor is financially weak, the funding target generally would be the plan's at-risk liability. A plan sponsor is considered financially weak if its senior unsecured debt is rated as below investment grade by every rating agency that rates the sponsor. A plan's funding target would phase up from ongoing to at-risk over a 5-year period. Conversely, if a plan's credit rating is upgraded to investment grade, its funding target would immediately drop to ongoing liability.

Credit ratings are used to measure financial health because empirical evidence shows that a company's time spent in below investment grade status is a strong indicator of the likelihood of plan termination. It is also critical that a market-based test be used to establish financial health.

A plan's ongoing liability is equal to the present value of all benefits that the plan is expected to pay in the future, based on benefits earned through the beginning of the plan year. Workers are assumed to retire and to choose lump sums as others have in the past. A plan's at-risk liability is based on the same benefits, but assumes that employees will take lump sums and retire as soon as they can, and includes an additional amount reflective of the transaction cost of winding up a plan. These assumptions are designed to reflect behavior that typically occurs prior to plan termination when the financial health of the employer deteriorates.

The applicable funding target is calculated by discounting benefit liabilities based on a yield curve of long-term corporate bonds. The discount rate would reflect the duration of the liabilities. A plan's actuary would project the plan's cash flow in each future year and discount payments using the appropriate interest rate for the payment. In general, with a typical yield curve, plans with older workforces where payments are due sooner will discount a greater proportion of their liabilities with the lower interest rates from the short-end of the yield curve than plans with younger workforces where larger cash payments are delayed into the future. The corporate bond yield curve would be published by the Secretary of Treasury and would be based on the interest rates, averaged over 90 business days, for high quality corporate bonds rated AA, with varying maturities.

The use of a single conceptual measure of liabilities will simplify the funding rules. It will tell plan sponsors, investors, regulators, and most importantly, workers and retirees, whether a plan is adequately funded.

Funding shortfalls should be made up over a reasonable period

Another problem with the current funding rules is that under-funded plans are permitted to make up their shortfalls over too long a period of time. In addition, under-funded plans are permitted funding holidays. These rules put workers at risk of having their plans terminate without adequate funding.

Under current law, if the unfunded accrued liability is attributable to a plan amendment, the amortization period for making up the shortfall is 30 years. Experience shows this is too long. There is too much risk that the plan will be terminated before 30 years has passed. Furthermore, collectively bargained plans often have a series of benefit increases every few years, which has the effect of increasing all of the liabilities accrued prior to the benefit increase as well as increasing future liabilities. As a result, these plans are perennially under-funded.

The credit balance rules for plan funding under current law also contribute to plan under-funding. The credit balance rules allow an employer to apply their contributions in excess of minimum requirements from an earlier year as an offset to the minimum funding requirement for a subsequent year without restrictions. This loophole allows a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market—and, more importantly, regardless of the current funded status of the plan. Credit balance rules harm the retirement security of workers and retirees. In the Bethlehem Steel and the U.S. Airways pilots' plan termination cases, for example, no contributions were made (or required to be made, as a result of credit balances) to either plan during the 3 or 4 years leading up to plan termination.

Under the administration's proposal, plans would annually contribute enough to address their funding shortfall over a reasonable period of time, without funding holidays, until the shortfall is eliminated. Plan funding shortfalls would be amortized over a 7-year period. The current-law provision allowing an extension of amortization periods would no longer be available.

Opportunity to increase funding in good years

We also must address the overly prescriptive funding rules for well-funded plans that discourage companies from building up a cushion to minimize contributions in lean years. To keep healthy companies in the defined benefit system, we need to give them better incentives.

The current funding rules can place a pension plan sponsor in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. This problem is caused by the interaction of the minimum funding requirements and the rules governing maximum deductible contributions. The rules restrict employers' ability to build up a cushion that could minimize the risk that contributions will have to be severely increased in poor economic times. This volatility in required contributions makes it difficult for plan sponsors to predict their funding obligations, and makes it difficult to prevent large required contributions during economic downturns when the company is least able to pay.

The administration's proposal would permit plan sponsors to make additional deductible contributions up to a new higher maximum deductible amount. This would permit companies to increase funding during good economic times. Funding would be permitted on a tax-deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year, the applicable normal cost and a specified cushion. The cushion amount would enable plan sponsors to protect against funding volatility, and would be equal to 30 percent of the plan's funding target plus an amount to pre-fund projected salary increases (or projected benefit increases in a flat-dollar plan). Plans would always be permitted to fund up to their at-risk liability target.

This cushion will help provide workers and retirees greater retirement security by increasing the assets available to finance retirement benefits.

Limitations on plans funded below target levels

The current rules encourage some plans to be chronically under-funded, in part, because they shift potential losses to third parties. This is what economists refer to as a "moral hazard." Under current law, sponsors of under-funded plans can continue to provide for additional accruals and, in some situations, even make new benefit promises, while pushing the cost of paying for those benefits off into the future. For this reason, some companies have an incentive to provide generous pension benefits that they cannot currently finance, rather than increase wages. The company, its workers 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. Under our proposed funding rules, financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they fund them in a reasonably timely manner.

If a company's plan is poorly funded, the company should be precluded from adopting further benefit increases unless it fully funds them, especially if it is in a weak financial position. If a plan is severely under-funded, retiring employees should not be able to elect lump sums and similar accelerated benefits. The payment of those benefits allows those participants to receive the full value of their benefits while depleting the plan assets for the remaining participants. A similar concern applies when a severely under-funded plan purchases annuities.

The administration believes that we must ensure that companies, especially those in difficult financial straits, make only benefit promises they can afford, and take steps to fulfill their promises already made by appropriately funding their pension plans. In order to accomplish this goal, the proposal would place additional meaningful limitations on plans that are funded substantially below target levels.

First, the rules would limit benefit increases for certain under-funded plans. For a plan where the market value of the plan's assets is less than or equal to 80 percent of the funding target, no amendment increasing benefits would be permitted. If the market value of the plan's assets is above 80 percent of the funding target, but was less than 100 percent for the prior plan year, then no benefit increase amendment that would cause the market value of the plan's assets to be less than 80 percent of the funding target would be permitted. In either case, the sponsor could avoid the application of these limits by choosing to contribute the minimum required contribution and the increase in the funding target attributable to an amendment increasing benefits.

Second, the rules would limit lump-sum distributions or other accelerated benefit distributions for certain under-funded plans. Limits would apply if either the market value of a plan's assets is less than or equal to 60 percent of the funding target or the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 80 percent of the funding target.

Third, the rules would limit accruals for plans with severe funding shortfalls or sponsors in bankruptcy with assets less than the funding target. A plan is considered severely under-funded if the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 60 percent of the funding target. These plans pose great risk of plan termination and would effectively be required to be frozen.

Lastly, the rules would address an abuse recently seen in the airline industry—where executives of companies in financial difficulty have their nonqualified deferred compensation arrangements funded and made more secure, without addressing the risk to the retirement income of rank and file employees caused by severely under-funded pension plans. The rules would prohibit funding such executive compensation arrangements if a financially weak plan sponsor has a severely under-funded plan. Also, the rules would prohibit funding executive compensation arrangements less than 6 months before or 6 months after the termination of a plan where the plan assets are not sufficient to provide all benefits due under the plan. A plan would have a right of action under ERISA against any top executive whose nonqualified deferred compensation arrangement was funded during the period of the prohibition to recover the amount that was funded.

Plans that become subject to any of these benefit limitations would be required under ERISA to furnish a related notice to affected workers and retirees. In addition to letting workers know that limits have kicked in, this notice will alert workers when funding levels deteriorate and benefits already earned are in jeopardy.

IMPROVING DISCLOSURE TO WORKERS, INVESTORS, AND REGULATORS

The financial health of defined benefit plans must be transparent and fully disclosed to the workers and their families who rely on promised benefits for a secure and dignified retirement. Investors and other stakeholders also need this information because the funded status of a pension plan affects a company's earnings and creditworthiness.

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.

For example, the principal Federal source of information about private-sector defined benefit plans is the Form 5500. Schedule B, the actuarial statement filed with the Form 5500, reports information on the plan's assets, liabilities and compliance with funding requirements. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed,

regulatory agencies are not notified of the plan's funded status for almost 2 years after the actual valuation date. If the market value of a plan's assets is less than its funding target, the relevant regulatory agencies need to monitor whether the plan is complying with the funding requirements on a more current basis.

The PBGC does receive more timely information regarding a limited number of under-funded plans that pose the greatest threat to the system under Section 4010 of ERISA. Section 4010 data provides identification, financial, and actuarial information about the plan. The financial information must include the company's audited financial statement. Sponsors also are required to provide actuarial information that includes the market value of their pension plan's assets, the value of the benefit liabilities on a termination basis, and a summary of the plan provisions for eligibility and benefits.

However, current law prohibits disclosure, so this information may not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan is vitally important to participants and investors. Making information regarding the financial condition of the pension plan publicly available would benefit investors and other stakeholders and is consistent with Federal securities laws that Congress has strengthened to require the disclosure of information material to the financial condition of a publicly-traded company.

The most fundamental disclosure requirement of a pension's funding status to workers under current law is the summary annual report (SAR). The SAR discloses certain basic financial information from the Form 5500 including the pension plan's net asset value, expenses, income, contributions, and gains or losses. Pension plans are required to furnish a SAR to all covered workers and retirees within 2 months following the filing deadline of the Form 5500.

Information on a plan's funding target and a comparison of that liability to the market value of assets would provide more accurate disclosure of a plan's funded status. Providing information on a more timely basis would further improve the usefulness of this information for workers and retirees.

The Bush administration's proposal

The administration's proposal would allow information filed with the PBGC to be disclosable to the public and would provide for more timely and accurate disclosure of information to workers and retirees.

Provide broader dissemination of plan information

Under the administration's 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."

Broadening the dissemination of information on pension plans with unfunded liabilities, currently restricted to the PBGC, is critical to workers, financial markets and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

Provide more meaningful and timely information

The President's proposal would change the information required to be disclosed on the Form 5500 and SAR. Plans would be required to disclose the plan's ongoing liability and at-risk liability in the Form 5500, 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.

The information provided to workers and retirees in the SAR would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last 3 years. The funding status would be shown as a percentage based on the ratio 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.

REFORMING PREMIUMS TO BETTER REFLECT PLAN RISK AND RESTORING THE PBGC TO FINANCIAL HEALTH

There are two fundamental problems with PBGC premiums. First, the premium structure does not meet basic insurance principles, including those that govern private-sector insurance plans. Second, the premiums do not raise sufficient revenue to meet expected claims. The single-employer program lacks risk-based underwriting standards. Plan sponsors face limited accountability regardless of the risk they impose on the system. As a result, there has been a tremendous amount of cost-shifting from financially troubled companies with under-funded plans to healthy companies with well-funded plans.

This excessive subsidization extends across industry sectors—to date, the steel and airline industries have accounted for more than 70 percent of PBGC's claims by dollar amount while covering less than 5 percent of the insured base.

The PBGC also needs better tools to carry out its statutory responsibilities in an effective way and to protect its ability to pay benefits by shielding itself from unreasonable costs. Recent events have demonstrated that the agency's ability to protect the interests of beneficiaries and premium payers is extremely limited. This is especially true when a plan sponsor enters bankruptcy or provides plant shutdown benefits—benefits triggered by a plant closing or other condition that are generally not funded until the event occurs. Currently, the agency has few tools at its disposal other than to move to terminate plans in order to protect the program against further losses.

The Bush administration's proposal

The administration's proposal would reform the PBGC's premium structure. The flat per-participant premium will be immediately adjusted to $30 initially to reflect the growth in worker wages since 1991, when the current $19 figure was set in law. This recognizes the fact that the benefit guarantee continued to grow with wages during this period, even as the premium was frozen. Going forward, the flat-rate premium will be indexed for wage growth.

In addition to the flat-rate premium, a risk-based premium will be charged based on the gap between a plan's funding target and its assets. Because the funding target takes account of the sponsor's financial condition, tying the risk-based premium to the funding shortfall effectively adjusts the premium for both the degree of under-funding and the risk of termination. All under-funded plans would pay the risk-based premium. The PBGC board—which consists of the Secretaries of Labor, Treasury and Commerce—would be given the ability to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and improve PBGC's financial condition. Charging under-funded plans more gives employers an additional incentive to fully fund their pension promises.

As part of improving PBGC's financial condition, additional reforms are needed. Plan sponsor bankruptcies and plant-shutdown benefits increase the probability of plan terminations and impose unreasonable costs on the PBGC. The proposal would freeze the PBGC guarantee limit when a company enters bankruptcy and allow the perfection of liens during bankruptcy by the PBGC for missed required pension contributions. The proposal also would prospectively eliminate the guarantee of certain unfunded contingent liability benefits, such as shutdown benefits, and prohibit such benefits under pension plans.

CONCLUSION

The Bush administration is committed to working with Congress to ensure that the defined benefit pension reforms included with the President's budget—strengthening the funding rules, improving disclosure, and reforming premiums—are enacted into law.

As I noted earlier, the primary goals of the administration's proposal are to improve pension security for workers and retirees, to stabilize the defined benefit pension system, and to avoid a taxpayer bailout of the PBGC. This can be achieved by strengthening the financial integrity of the single-employer defined benefit system and making sure that pension promises made are promises kept. We look forward to working with members of this committee to achieve greater retirement security for the millions of Americans who depend on defined benefit plans.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: I am very concerned with some of the administration's suggestions for limiting benefit increases and accruals. It seems to me that these changes would

punish workers in cases where company management fails to invest enough money in the pension plan.

The administration has claimed that these benefit restrictions would prompt workers to put pressure on employers to better fund pension plans. However, it is not clear to me how workers could effectively stop employers from under-funding plans.

I would like to hear how you expect workers to protect themselves, and please specifically address how they could do so *between* contract negotiations as their benefits are being cut.

I would also like to know what would prevent an employer from purposely under-funding the pension plan in order to deprive workers of hard-won pension benefit increases?

Answer: The administration believes that we must ensure that companies make only benefit promises they can afford, and keep the promises already made by appropriately funding their pension plans. When companies are unable to keep their pension promises, the losses are shifted to the pension insurance system and to workers. It is these empty promises that harm workers by putting their retirement security at risk. The new stronger minimum funding rules combined with the proposed limitations will prevent companies from making hollow promises.

The stronger minimum funding rules will prevent employers from purposely under-funding their pension plans. Companies will be required to fund their plans up to a meaningful funding target. Companies that fall below the minimum funding target will be required to fund up to the target within a reasonable period of time. A plan sponsor that is operating outside of bankruptcy cannot ignore its funding obligations without serious consequences. There are significant enforcement measures available to the IRS and the PBGC to prevent firms from ignoring funding obligations.

The proposed benefit limitations will apply only when a plan's funded status falls below acceptable levels. The limit on benefit increases for certain under-funded plans will prevent companies from promising additional benefits unless promises already made to workers are adequately funded. The limit on accruals will apply only for plans with severe funding shortfalls or sponsors in bankruptcy with under-funded plans. The limitations will not affect benefits already earned. Rather than deprive workers of hard-won pension benefit increases, we believe that these proposals create a strong incentive for employers to adequately fund their plans—making it more likely that workers' retirement expectations will be met. Our proposal takes into account existing collective bargaining agreements by not applying these benefit limitations until the earlier of the end of the contract term or 2009.

Plans that become subject to any of the benefit limitations will be required to notify affected workers, making them aware that deteriorating funding is threatening their benefits. Workers need this information so that they can have realistic expectations about their company's ability to fund pension promises. We also believe that in some instances, companies will improve the funding of their plans in order to avoid notifying workers and thereby creating worker dissatisfaction.

Question: I am very concerned that the administration has made no proposal to address the pension crisis in the airline industry. A considerable amount of the deficit facing the PBGC is expected to derive from failing airline pension plans. Yet the administration has proposed no remedies specific to that industry that would help airlines maintain their plans.

Some airlines have asked Congress to consider relief that would allow them to essentially restructure their pension plans. By giving the companies a longer time period to pay off debt and perhaps limiting the PBGC's exposure to increases in pension liabilities, airlines may be able to save their pension plans.

What industry-specific relief is the administration willing to consider to protect the pension benefits of airline employees and help the companies maintain promises they made to their workers?

Answer: We understand the financial difficulties the airlines are facing. Congress and the administration have provided assistance to the airlines in the form of grants, loan guarantees, and short-term funding relief when such assistance was determined to be appropriate.

The administration's pension reform proposal would strengthen the funding rules to improve the health of the entire defined benefit pension system. This is particularly important for those under-funded plans that pose the greatest risk of terminating. Neither the defined benefit system nor the pension insurance system is designed to provide or capable of providing targeted relief to specific industries. It is designed to insure benefits for participants in plans that fail.

Relaxing the funding rules for a specific industry would set a dangerous precedent for the pension insurance program. We do not believe that the interests of partici-

pants, other premium payers, or the taxpayer are best served by allowing companies to effectively borrow from their employees and the insurance fund to meet their financial obligations.

I would also emphasize that the majority of losses incurred by the PBGC to date have been in industries other than airlines and that the majority of the insurance fund exposure to "reasonably possible" claims is in other industry sectors. So, the financial pressures on the pension insurance program are not unique to the airline industry.

Current law allows plan sponsors to obtain funding waivers if they are experiencing temporary substantial business hardship. The IRS can, in consultation with the PBGC, and often does, impose conditions on obtaining a waiver that protect the interests of participants and the pension insurance program.

Question: I appreciate the difficulty we are facing in trying to shore up the defined benefit pension plan system. On the one hand, we want to better protect workers by making sure that employers are adequately funding their pension promises. On the other hand, we want to encourage employers to continue to provide defined benefit pensions that protect workers and retirees from the risks associated with the stock market.

I am very concerned that the administration's proposal focuses just on addressing the deficit faced by the PBGC. Many aspects of this proposal would increase funding to the PBGC, but actually make it much harder for employers to maintain these plans.

For example, the yield curve proposed by the administration would be much more volatile and difficult for employers to predict and plan for. The yield curve also substantially increases the liability calculations for industries that have older workers. Even healthy plans would see substantial premium increases under the administration's reforms.

I am concerned that these are shortsighted fixes to the PBGC's funding problems. As defined benefit plans become more and more expensive for employers, many companies will simply shift away from offering such pensions. As healthy plans voluntarily terminate, the funding problems in the system increase, creating a vicious cycle.

How does the administration propose to encourage companies to continue to offer defined benefit plans?

Answer: We would respectfully disagree that the administration's proposal focuses just on improving the pension insurance program deficit or that it would or should cause employers to abandon their pension plans. We believe the proposal appropriately balances competing considerations. The objective is to ensure that plan sponsors honor the promises they have made, and the proposal requires companies to make up their funding gap over a reasonable period of time. At the same time, the administration's proposal provides additional flexibility for plan sponsors and provides numerous incentives for them to maintain and prudently fund the plans they sponsor.

For example, companies will be able to make much larger tax-deductible contributions to their plans during good economic times than under current law. Companies that contribute more than the minimum requirement would effectively shorten the amortization period. They would be able to reduce the amount of risk-based premium that would have to be paid. And companies would likely benefit from improved credit ratings if they reduced their unfunded pension liability, thus lowering their cost of capital.

We also do not agree that the administration's proposal would lead to greater volatility and make it more difficult for companies to predict their funding requirements. The risk and volatility in the pension plan is a function of the business decisions made by the company. Current law simply masks that volatility and allows companies to shift the risks to third parties. It is because of current-law features like smoothing and credit balances that plans sometimes are so under-funded when they terminate. Hiding the problem doesn't make it go away. There are numerous ways under the administration's proposal in which companies can minimize risk and volatility and make funding more predictable.

The administration also believes that Congress should act promptly to clarify the legal status of cash balance and other hybrid pension plans. The only new defined benefit plans created in recent years have been alternative benefit structures, such as cash balance or pension equity plans that are designed to meet the needs of a younger, more mobile workforce. Unfortunately, as a result of a single Federal court decision, the legal status of these types of plans is in question.*

* *Cooper* v. *IBM Personal Pension Plan,* 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have

RESPONSES TO QUESTIONS FROM SENATOR SMITH

PAYOUT OPTIONS

Question: So many of the demographic figures I have seen lately speak to the fact that more and more of the responsibility for accumulating retirement savings is shifting to the individual. Half of American workers get help from their employers in the form of employer-provided savings, and half of our workers must do it on their own. Of course we're here discussing some of the ways to achieve further security for those who do have such access to traditional pensions and what can be done to make them more secure.

I have actually introduced legislation that would give the same guaranteed payout streams as traditional pensions to those who do not have access to such employer-provided plans. What the legislation provides is an incentive to consider the "delayed gratification" of an annuitized payout you can't outlive when compared against the "instant gratification" of receiving a simple lump sum.

The reason why I raise this issue is that even the defined benefit pension plans we are discussing today are trending increasingly toward paying lump sums at retirement; in particular, cash balance plans. For those of us concerned that retirees need to consider taking a guaranteed payout stream rather than just a lump sum, what can you tell me about your plans that will create some payout options for retirees?

Answer: The administration's funding proposal will strengthen and preserve the defined benefit system. Preserving the system will enable more workers to have the option of taking their pension distributions in the form of annuities. The administration's proposal also eliminates an inappropriate incentive for participants to take lump-sum distributions.

Under current law, the use of an inappropriately low discount rate for determining the value of lump sums creates an incentive for participants to choose lump sums. Under our proposal, the yield curve would be used to calculate minimum lump sums, which will eliminate this distortion that can bias a participant's payout decision toward lump sums. 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.

MULTIEMPLOYER PLANS

Question: It is my understanding that the administration is not planning on taking any action on multiemployer plans in the near future. However, there is a crisis brewing among the multiemployer plans as well. Some very large plans are close to having to go into "reorganization," and many retirees in my State of Oregon will be impacted. Does the administration plan on reporting to us on the risk that the multiemployer system would have to assume if some of these multiemployer plans become insolvent?

Answer: The administration recognizes that changes in the multiemployer funding rules are necessary. However, we focused on single-employer plans first because the problems facing single-employer plans are more immediate and acute. Also, due to the unique nature of multiemployer plans, not all elements of the single-employer proposal could be immediately applied to multiemployer plans. We believe it is vitally important that Congress enact legislation to protect the retirement security of workers in these single-employer pension plans. At the same time, however, we must remember that there are millions of Americans who are covered by multiemployer pension plans, and that their retirement security is equally important. We should work together in a bipartisan fashion to ensure that multiemployer plans are strengthened.

The multiemployer insurance program covers about 9.8 million workers and retirees in about 1,600 plans. The program has only one source of funds, an annual premium payment of $2.60 per participant that generates about $24 million of income per year.

The PBGC insurance comes into play when a multiemployer plan becomes insolvent—that is, when the plan does not have enough assets to pay benefits that fall under the statutory limit, which was originally set at less than $6,600 per year for a retiree with 30 years of service. In 2001, Congress amended the law to double the limit—to $12,870 per year—but did not increase the premium. Between 1980 and

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disagreed. *Tootle* v. *ARINC, Inc.,* 222 F.R.D. 88 (D. Md. 2004); *Eaton* v. *Orion Corp.,* 117 F. Supp. 2d 812 (S.D. Ind. 2000).

2000, relatively few multiemployer plans failed; the agency paid out $167 million to some 33 plans.

Recently, however, more plans have failed. In its 2004 Annual Report, PBGC estimates that financial assistance payments to multiemployer plans denoted as "probables" will reach $30 million in 2005, $90 million in 2006, and $100 million per year for at least a decade thereafter. In addition, it is "reasonably possible" that other multiemployer plans will require future financial assistance in the amount of $108 million in present-value terms.

The multiemployer program ran surpluses for over 20 years until it recorded its first deficit of $261 million in FY 2003. The multiemployer program reported a deficit of $236 million in FY 2004. This is in contrast to the $23.3-billion deficit in the single-employer program.

In the 2004 Annual Report, PBGC estimated that, as of September 30, 2004, the total under-funding in insured multiemployer plans is more than $150 billion, compared to a 2003 estimate of more than $100 billion.

The Government Accountability Office recently completed a study that concluded that multiemployer plans face long-term challenges, and we agree with this assessment. Because multiemployer plans are creatures of collective bargaining, the dwindling percentage of union coverage in private-sector employment has halted growth. In addition, a substantial number of plans are concentrated in industries such as trucking and retail foods, where employers and unions will encounter increased cost competition from new competitors.

The PBGC is required by law to review the multiemployer plan insurance program every 5 years to assess, in a report to Congress, whether changes in the current guaranteed benefit can be supported by the existing premium structure. The PBGC expects to complete work on the next 5-year report in late 2005.

PBGC LIABILITY

Question: In measuring its liability, the PBGC has historically used an interest rate that is well below market rates. What would the PBGC's deficit be using the corporate bond interest rate that Congress enacted last year? And, what would the PBGC deficit be using the administration's yield curve methodology?

The administration's proposals would require some employers to make much larger pension contributions starting right away. How much modeling has the administration done to determine how many companies would not be able to meet those sudden increases in cash flow demand? How certain are you that we will not see more bankruptcies as a direct result of this proposal and that you will only be turning some of those "probables" into "definite problems" for the PBGC?

Answer: Actually, the PBGC does use market prices for valuing its liabilities both on its financial statements and for our claims in bankruptcy. The PBGC conducts surveys of the prices charged by private-sector insurance companies to write group annuity contracts and derives an interest factor from those prices that, with PBGC's mortality table, will match the prices. The rationale for this approach is that it maintains a "level playing field" between plans that terminate with PBGC and plans that terminate in the private sector. Put another way, if a plan sponsor determined to terminate its plan (which would have to be fully funded) and annuitize the benefits to its employees, a private-sector annuity provider would value those liabilities the same way that PBGC does.

Using an interest factor based on prices for annuities charged by private-sector insurance companies, the PBGC's single-employer deficit was $23.3 billion. If PBGC had valued liabilities using 100 percent of the spot corporate bond rate that is currently used for determining PBGC premiums, the deficit would have been about $18 billion. (Pursuant to legislation enacted by Congress last year, the corporate bond rate is used differently for different purposes: (1) a 4-year weighted average is used to determine plan funding, and (2) a spot rate is used to determine PBGC premiums.) If, instead, the PBGC had valued liabilities using the administration's yield curve methodology, the deficit would have been about $19 billion. Both estimates assume that PBGC would continue to include in liability estimates the present value of its own future expenses as it does under current procedures. It is also important to note that while the single-employer deficit would be lower using these approaches, there still would have been a dramatic swing in the corporation's financial position from a surplus to a very large deficit over the past 3 years.

We have modeled the proposal in the aggregate for the entire defined benefit system. The data indicate that the funded status of both healthy ongoing and at-risk plans improves over time under the administration's proposal, which is the core objective of reform. We should not lose sight of the fact that the current funding rules don't work and have allowed the huge funding gap to develop and grow. Absent the

kind of fundamental changes in the administration's proposal, there is a significant risk that the level of under-funding in terminated plans will get much larger. We do not have the information needed to evaluate the financial impact of the proposal on particular plan sponsors. We believe that the funding rules should apply to all plan sponsors, and it would be inappropriate to create special rules for a particular industry or company.

Various underlying business factors apart from pension funding lead to corporate bankruptcies. That will continue to be the case in the future. If we make no changes in the funding rules or further relax them, plans of bankrupt firms will be more under-funded, participants will lose more benefits, and the taxpayer will be put at greater risk.

It is in everyone's best interest to keep well-funded plans in the defined benefit system. At the same time, as we have seen, plan under-funding is destabilizing to the system. These concerns are fairly and effectively addressed by the administration's proposal, which would require funding of benefit promises over a reasonable period of time.

PREPARED STATEMENT OF HON. CHARLES GRASSLEY

Today, the Finance Committee will hear testimony on the state of defined benefit pension plans. We will focus on the government backer of that system, the Pension Benefit Guaranty Corporation, or "PBGC," and the administration's recent proposal to strengthen pension funding. Defined benefit plans are a critical part of our Nation's pension system and our economy as a whole. These plans provide retirement income to millions of Americans. Millions of current workers count on these benefits as they look forward to retirement. Today, our defined benefit pension system is clouded with uncertainty. There is uncertainty for plan sponsors regarding the interest rate used to calculate their pension liabilities. And there is uncertainty for participants who read the headlines and wonder if their pension benefits will really be there for them when they retire.

In the last Congress, attention began to focus on replacing the 30-year Treasury rate for pension funding purposes with a new rate. At the same time, questions began to be raised whether we needed to take a more comprehensive look at reforming the pension funding rules. Here in the Finance Committee, we worked in the bipartisan tradition of this committee on the NESTEG bill. NESTEG included a permanent replacement for the 30-year Treasury rate with the yield curve along with a first round of proposals from the administration to strengthen pension funding. In acting on NESTEG, I along with Senator Baucus also asked the administration to provide details on the more comprehensive pension funding reforms on which they were working.

We now have those details, and will spend a considerable amount of time here today discussing and debating them. I look forward to a spirited and thought-provoking discussion. I believe it is critically important that we enact a permanent set of pension funding rules this year. It is critically important for our economy. It is critically important for the companies that sponsor these plans. Most of all, it is critically important for the workers who depend on these plans for their retirement. To that end, Senator Baucus and I have re-introduced last year's committee-reported NESTEG bill, and announced our intention to work to reform the pension funding rules in a permanent manner. Defined benefit plans are a vital part of our private retirement system. At the same time that we recognize the defined benefit pension system's many good attributes, however, we must be mindful of its current problems.

The PBGC's current deficit is $23 billion. That's $23 billion of exposure for all taxpayers. Most of those taxpayers do not have a stake in the defined benefit system. Only about 20 percent of workers have a defined benefit plan today. About half of workers lack an employer-provided retirement plan—either defined benefit or defined contribution—altogether. That's a sad and disturbing statement in itself. Hopefully, we can move that percentage up a lot. To the extent that progress has been made on increasing retirement plan coverage, this committee has been largely responsible. I worked to have retirement savings provisions included in the 2001 tax cut. And I've enjoyed a long relationship working with Senator Baucus on increasing coverage and improving our retirement system. One such idea is the bipartisan savers' credit that my friend, Senator Baucus, pursued with others in the 2001 tax act.

Since only about 20 percent of workers participate in the defined benefit system, one question we have to confront is whether the other 80 percent of workers not covered by a defined benefit plan should be responsible for subsidizing the pension benefits of the minority who do. There are other alarming trends to note as well.

Many employers, particularly those in older industries, have over-promised or under-funded, and often both. Those promises are now coming due. Too often, these businesses, with the collaboration of unions, act as if their obligations to their workers are the taxpayers' responsibility.

Far too often, large companies have cavalierly sloughed off their defined benefit liability onto the taxpayers. Far, far too often the taxpayers have ended up holding the bag on a badly-negotiated employee benefit deal. The administration, to its credit, has stepped up with a tough defined benefit reform package that would strengthen pension funding. The predictable howling from some employers and union groups has begun. I'd say to the howlers, we're, as Ross Perot used to say, "all ears." But, what we don't want to hear is complaints only. If you don't like the administration's tough medicine, what's your solution? How do you assure the taxpayers that we're not digging a bigger deficit ditch at the PBGC? How do you assure current retirees that they can count on a funding source for the benefits that were promised to them? How do you assure current workers that their promised defined benefits won't be defined and paid by the Federal Government? I'm looking for answers here. I'm not looking for complaints without constructive alternatives.

While we're talking about constructive alternatives, I'd like everyone in Congress to consider turning off the anti-Social Security reform water cannon for an afternoon. Let's put away the attack charts, shut down the gimmicky biased benefit calculators, focus on solving a problem, and do the people's business. Instead of strident statements against any effort to reform Social Security, I'd like us to recognize that President Bush has raised the profile of our Nation's retirement security challenges. He has used the bully pulpit to put retirement security issues front and center. Let's not waste the opportunity. I'm still hopeful that the Finance Committee can rise above the discussions taking place over the air waves on Social Security and work toward a long-term solvency proposal. Perhaps fixing the defined benefit plan system can be part of that effort. We owe it to the people who sent us here to focus on these problems. Most of us got on this committee to solve problems, and we're going to do that.

PREPARED STATEMENT OF RANDALL S. KROSZNER

Good afternoon, Chairman Grassley, Ranking Member Baucus, and members of the committee. I am delighted to be invited before you to discuss the single-employer defined benefit pension system and the Pension Benefit Guarantee Corporation (PBGC). I applaud the committee for taking up this important and complicated issue at this time, because I believe that the system is in crisis and in urgent need of fundamental reforms. It is a ticking time bomb waiting to explode, and the longer we wait to defuse it, the more powerful the blast will be.

The PBGC, a government-sponsored enterprise that takes over the pension obligations of financially troubled firms, reported a deficit of $23.3 billion at the end of the 2004 fiscal year, up from $11.2 billion a year earlier. The PBGC also projected a "reasonably possible" exposure of roughly $96 billion. In its "base case" estimate, the Center on Federal Financial Institutions, a non-partisan watchdog organization, projects a $78 billion deficit for the PBGC. These are disturbingly large numbers that are likely to grow over time if no reforms are undertaken. Simply standing idly by and watching the deficits grow would undermine the security of the retirement benefits of employees and retirees and expose the taxpayer to ever greater costs.

DEJA VU ALL OVER AGAIN: DON'T LET PBGC BECOME THE S&L CRISIS OF THE NEW MILLENNIUM

The situation at the PBGC today closely parallels the situation in the Savings and Loan industry and its insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), in the 1980s. First, the FSLIC was a government-sponsored enterprise that insured deposits of S&Ls up to $100,000, much as the PBGC provides insurance for pension plans up to a current maximum per retiree of approximately $45,000 per year. Second, both the FSLIC and the PBGC financed themselves by levying insurance premiums. Third, in neither case did or does the premium vary with the risk of the underlying thrift or employer. Fourth, a series of economic shocks caused financial trouble in thrifts and in industries using defined benefit pension plans. During the 1980s, higher interest rates and a sharp decline in real estate values in many parts of the country, for example, pushed many thrifts either into insolvency or to the brink of insolvency. The recession of 2001, the shocks of 9/11, and poor investment choices have led many defined benefit plans to become significantly under-funded, with estimates of this under-funding exceeding $400 billion. Fifth,

these financial troubles led both the FSLIC and the PBGC to become effectively insolvent, that is, their expected liabilities far outstripped their assets.

The sixth, and the most disturbing parallel, is that many observers—both in the 1980s for the FSLIC and for the PBGC today—acknowledge that the agencies face challenges but that the trouble is/was simply a temporary phenomenon. As the economy recovered from recession in the early 1980s, many argued that the thrift problem would right itself. Thus, no fundamental policy change was necessary. This is the policy of "forbearance," that is, wait and hope with fingers crossed. Many commentators are advocating the same wait and hope policy for pension system today.

As the sad history of the thrift crisis demonstrates, the wait and hope policy was a disaster. Despite a robust overall economic growth after 1982, troubled thrifts never recovered. Many took high risks, ultimately at taxpayer expense. This is the so-called moral hazard problem: if you provide insurance at below market rates that do not adequately adjust for risk, recipients of the insurance, especially those who are in financial difficulties, will take on greater risk. They do this because they have little to lose, that is, if the thrift is insolvent or financially troubled, the owners have little or nothing at stake. The depositors don't care because they know that they have the guarantees, so troubled thrifts could continue to gather deposits, often by paying slightly higher interest rates to attract large inflows of money. The taxpayer was left to bail-out the depositors at a cost exceeding $100 billion. If the trouble had been resolved earlier, the costs would have been much lower (*see* Kroszner and Strahan 1996).

The current pension system suffers from exactly this moral hazard problem, and forbearance will only make it worse. Firms falling into financial distress or in bankruptcy in particular tend to defer funding their pension obligations. The current system of funding rules allows firms to have significant pension funding gaps for long periods with little or no consequence. In addition, much as in the S&L crisis, employers have an incentive to invest in excessively risky assets, hoping that a lucky pay-off will make up for the funding gap. Since the PBGC provides the guarantees of the obligations, the employees (much like the insured depositors in the S&Ls) are willing to tolerate more funding shortfalls and risks in the pension system than they otherwise would. In addition, the system provides an incentive for financially troubled employers to promise larger pension benefits in return for wage concessions, and employees might accept this due to the PBGC guarantee. The ability of financially troubled firms to delay pension funding and offer continuing and, in some cases, increased benefits despite large funding shortfalls and risky pension investments, is at the heart of the moral hazard problem in the pension system today (*see* Kroszner 2003).

"PROMPT CORRECTIVE ACTION" PROVISIONS OF FDICIA PROVIDE GUIDELINES FOR PREVENTING CRISIS

To avoid an enormous and inappropriate taxpayer-financed bail-out of the PBGC, action must be taken swiftly. Fortunately, we can learn from the S&L experience what should be done. The 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) introduced two important changes that have dramatically reduced moral hazard in the depository institutions and have helped to strengthen the industry so that it could weather recession and shocks from 9/11 with very few failures or troubles. Depository institutions have been thriving since these changes were implemented.

FDICIA permitted insurance premiums to increase to provide greater assets for the deposit insurance agency to cover its obligations and, importantly, for the premiums to vary with risk. These were extremely important steps in returning the deposit insurance system to solvency and reducing moral hazard. In the context of PBGC, given its large and increasing deficits, it is clear that the current levels of premiums are below the actuarially appropriate level. Thus, increasing premiums will help to increase the security of insured retirement benefits and reduce the potential exposure of the taxpayers.

In addition, premiums must be permitted to adjust for the risk. The application of this basic principle of economics and finance has done much to reduce the moral hazard incentives to take on excessive risk. If premiums vary with risk, then thrifts and employers will have to pay a cost of taking on excessive risk, unlike in a system premiums that are not risk-sensitive. When premiums are not risk-adjusted, the guarantee system effectively subsidizes risk taken, and ultimately the taxpayer may bear the burden of these excessive risks. Thus, PBGC premiums should be adjusted to take into account the risks that a particular plan poses. These include the extent of the funding gap, the riskiness of the assets in the pension portfolio, and the likelihood that the PBGC will have to take over the obligations (*e.g.,* a proxy for the prob-

ability of financial distress, bankruptcy, and the "putting" of the pension obligations to the PBGC). By structuring the premiums this way, firms are rewarded for funding their pension plans adequately and conservatively and are punished for underfunding and taking excessive risks. This is one important means of reigning in the moral hazard problem and improving the retirement security of employees.

Another extremely important aspect of FDICIA that has helped to reduce moral hazard problems is the requirement of "prompt corrective action" against depository institutions that are in financial trouble and taking on excessive risk (*see* Kroszner 2000). As an institution falls into distress, prompt corrective action restricts the activities of the institution to reduce its risk-taking behavior and requires the institution to resolve its problems quickly. In the context of the current pension system, the parallel to prompt corrective action would involve two reforms: first, eliminate the ability of firms in distress to increase their (guaranteed) pension obligations; and second, require that under-funded plans return to adequate funding levels quickly. In the prompt corrective action provisions of FDICIA, the further that an institution is out of compliance with its obligations, the more restrictions are put on its activities and the greater the obligations to come into compliance. This graduated approach of taking the greatest actions against the plans with the greatest shortfalls and risk makes much sense in the pension area also.

CONCLUSION

Without fundamental reform, the single-employer defined benefit system in the U.S. faces a major crisis. To ensure the security of retirement benefits for employees and retirees and to protect the system from inefficiencies of moral hazard (and thereby reduce taxpayer exposure), reforms parallel to those introduced by the FDICIA are necessary. In undertaking reform, I urge your committee to make a serious assessment of the objectives of the system and explore options that might involve harnessing greater use of market forces in achieving security of the pension system without encouraging undue risk (*see* Kroszner 1999). One question that arises is whether a government-sponsored enterprise is the best way to achieve the objectives. For instance, the Congress has successfully moved Sallie Mae, the government-sponsored enterprise that guarantees student loans, into the private sector. In the home mortgage area, private mortgage insurers provide guarantees that allow many to purchase homes who otherwise could not receive a mortgage. Investigating the feasibility of some form of private insurance or of the purchase of annuities by employers for their employees would be valuable, in addition to the immediate reform of the PBGC.

Thank you very much for the honor of allowing me to express my views before the committee, and I will be happy to answer any questions you may have.

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RESPONSE TO A QUESTION FROM SENATOR BAUCUS

Question: In your testimony, you draw parallels between the Savings and Loan crisis and the current PBGC deficit situation. You offer the success of FDIC reforms as a model for ensuring the solvency of the defined benefit system and PBGC. Could you comment on how the voluntary nature of the defined benefit system affects the outcome of proposed reforms?

Answer: In my testimony, I described a number of close parallels between the S&L crisis and the current difficulties with the defined pension system and the PBGC. I then focused on two aspects of current proposed reforms that have parallels in the legislative responses to the S&L crisis. First, insurance premiums were increased and related to risk of failure. Second, "prompt correct action" (PCA) provisions have required that regulators restrict activities of firms most at risk of failure

to reduce risk-taking behavior and to demand that troubled firms act quickly to develop plans to resolve financial problems. I believe that these changes have been important in reducing moral hazard problems and reducing the potential exposure of taxpayers.

As you note, participation in the defined benefit system is voluntary, that is, employers are not required to offer this particular form of pension, and employees may opt for jobs with different pension schemes. I believe that the analysis in my testimony concerning the FDIC reforms does apply to the defined benefit pension system.

First, from an economic point of view, it is a problem if insurance premiums do not reflect the underlying costs that the insurance imposes on the PBGC (and, potentially, upon the taxpayer). If premiums are set too low and do not adequately reflect risks—much as during the 1980s in the S&L crisis—, then institutions will have incentives to take on excessive risks, thereby potentially undermining the stability of the system as a whole and exposing the PBGC (and, potentially, the taxpayers) to large liabilities. The incentives given by the pricing of insurance affect the voluntary actions of actors and institutions in the marketplace and lead them to make choices involving excessive risk. Changing the premiums to better reflect the expected liability exposure of the PBGC would likely change the choices that market participants make, and would reduce risk and thereby enhance the stability of the system.

Second, PCA also can be an important tool to affect the voluntary choices of actors and institutions regarding the defined benefit pension system. As we observed during the S&L crisis, businesses that are facing distress may choose to take on excessive risks, particularly when the depositors or the pensioners have FDIC or PBGC insurance. PCA can restrict those choices to reduce the risk-taking behavior and, thereby, help to reduce the exposure of the guaranteeing institution, such as the PBGC (and, potentially, the taxpayer). Preventing a distressed firm from increasing its (guaranteed) pension obligations and requiring prompt remedial action for significantly under-funded plans can be valuable tools for ensuring the health of the defined benefit pension system and the PBGC.

Prepared Statement of Alan Reuther

INTRODUCTION

The UAW appreciates the opportunity to testify before the Senate Finance Committee on the financial position of the Pension Benefit Guaranty Corporation (PBGC) and the administration's funding proposals for single-employer defined benefit pension plans (hereinafter referred to as "pension plans"). We look forward to working with the committee as it considers these important issues.

The UAW represents 1,150,000 active and retired employees in the automobile, aerospace, agricultural implement and other industries. Most of our active and retired members are covered under negotiated pension plans.

The UAW has a long and proud history of involvement in legislation relating to these pension plans. We were in the forefront of the decade-long struggle to enact ERISA, which led to the establishment of the PBGC. We also were actively involved in the enactment of legislation in 1987 and again in 1994 to strengthen the funding of pension plans and the PBGC.

The UAW believes Congress once again needs to adopt balanced proposals that will strengthen the funding of pension plans and encourage employers to continue these plans. We also support new measures to bolster the PBGC and the security of pension benefits for workers and retirees.

Unfortunately, the package of proposals advanced by the administration will not achieve these objectives. In our judgment, the administration's pension proposals are dangerous and counterproductive. They would punish employers who are already experiencing financial difficulties, resulting in more pension plan terminations and loss of retirement benefits, more bankruptcies, plants closings and layoffs, more liabilities being dumped on the PBGC, and more employers choosing to exit the defined benefit pension system. As a result, these proposals would be bad for employers, bad for workers and retirees, bad for the PBGC and bad for the entire defined benefit pension system.

The UAW urges the Finance Committee to reject the administration's proposals, and instead to put forward a bipartisan package of proposals that will improve the funding of pension plans and bolster the PBGC, without punishing employers, workers and retirees. We stand prepared to work with the committee to achieve these objectives.

I. STRENGTHENING THE FUNDING OF PENSION PLANS

The UAW supports balanced legislation to strengthen the funding of pension plans. These reforms should be designed to ensure that benefits promised by employers to workers and retirees are adequately funded, thereby improving the security of these benefits and also reducing the PBGC's exposure for unfunded pension liabilities.

However, the UAW believes it is imperative that any new funding rules should be structured so as to provide predictable, stable funding obligations for employers and to reduce the volatility of required contributions from year to year. New funding rules should also encourage employers to contribute more than the bare minimum in good times, and avoid counter-cyclical requirements that punish employers during economic downturns.

Unfortunately, the funding proposals advanced by the administration fail to meet these common-sense objectives. The UAW strongly opposes the administration's funding proposals because they would result in highly volatile pension funding obligations, would reduce incentives for employers to contribute more than the bare minimum, and would punish employers who are already experiencing economic difficulties.

(A) Interest rate assumption

The UAW strongly opposes the administration's proposal to require employers to use a so-called yield curve in establishing the interest rate assumption for pension plans. Under this proposal, the interest rate would be based on a near-spot rate (averaged over only 90 days), with a different interest rate being applied to each payment expected to be made by the plan based on the date on which that payment will be made.

This proposal has a number of fundamental problems. First, it would be extremely complicated, imposing considerable administrative burdens on plan sponsors. These burdens may discourage employers from continuing defined benefit pension plans (especially small- and mid-sized companies).

Second, contrary to the administration's assertions, the yield curve would not provide greater "accuracy" in setting the interest rate assumption. Because there is no real market for corporate bonds of many durations, these interest rates would largely be fictitious.

Third, the yield curve would result in highly volatile funding requirements that would fluctuate widely as interest rates change over time. This increased volatility would create enormous difficulties for employers, who need stability and predictability in their funding obligations. Indeed, the increased volatility would be a powerful incentive for employers to exit the defined benefit system.

Fourth, the yield curve would impose higher funding obligations on older manufacturing companies that have larger numbers of retirees and older workers. As a result, it would exacerbate the competitive disadvantage that many of the companies currently have because of heavy legacy costs, and would punish companies that are already experiencing economic difficulties.

Instead of this dangerous and counterproductive yield curve proposal, the UAW urges the Finance Committee to make permanent the long-term corporate bond interest rate assumption that was included in the temporary legislation enacted by Congress last year. In our judgment, this long-term corporate bond interest rate assumption would provide an economically sound and accurate basis for valuing pension liabilities, would be administratively simple for plan sponsors to implement, would result in stable and predictable funding obligations for employers, and would avoid imposing unfair, counter-cyclical funding burdens on older manufacturing companies.

At the same time, the UAW urges the Finance Committee to allow employers to use collar-adjusted mortality tables in valuing their plan liabilities. This would enable employers to more accurately value the future benefit obligations, especially for older manufacturing companies with larger numbers of retirees and older workers.

(B) Improving plan funding

The UAW strongly opposes the administration's proposal to throw out the existing funding rules in their entirety, and to replace them with new funding rules based on spot valuations of assets and liabilities, with no smoothing mechanisms, and with funding targets tied to a company's credit rating. These changes would introduce an enormous element of volatility into pension funding requirements. This would make it much more difficult for companies to plan their cash flow and liability projections, and thus would provide yet another powerful incentive for employers to exit the defined benefit pension system. In addition, these changes would punish companies that are already experiencing economic difficulties and have poor credit ratings, by

imposing sharply higher funding obligations on these employers. The net result could be more bankruptcies, job loss and plan terminations, with even more unfunded liabilities being transferred to the PBGC.

Instead of this counterproductive approach, the UAW urges the Finance Committee to support changes in the existing deficit reduction contribution (DRC) rules that would lead to improved funding of pension plans, but also provide smoother, more predictable funding obligations for employers and less onerous, counter-cyclical burdens on employers experiencing a temporary downturn. We believe this could be accomplished through two changes: (1) modifying the trigger for the DRC so that it applies to a broader universe of plans, and also is triggered more quickly when a plan becomes less than fully funded; and (2) reducing the percentage of the funding shortfall that must be made up in any year, so there will be a smoother path towards full funding. These changes would help to ensure that more employers are required to make up funding shortfalls in their plans, and are required to begin taking this action sooner. At the same time, these changes would avoid wild swings in a company's funding obligations that can have negative, counter-cyclical effects, especially on employers who are already experiencing economic difficulties.

The UAW also urges the Finance Committee to adopt changes to the general ERISA funding rules to shorten the amortization period for plan amendments from 30 to 15 years. This would bring this amortization period more in line with the average remaining working life of most participants. It would require more rapid funding of benefit improvements, and thereby help to improve the overall funding of pension plans.

Finally, the UAW supports modifying the definition of "current liability" to take into account lump-sum distributions reasonably projected to be taken by plan participants. This would require plans to provide adequate funding to cover anticipated lump-sum distributions, and help to prevent situations where plans have been drained because of such distributions.

(C) Credit balances

The UAW strongly opposes the administration's proposal to completely eliminate credit balances, which are currently created when an employer contributes more than the minimum required under existing funding rules. By eliminating credit balances entirely, the administration's proposal would have the perverse effect of discouraging companies from contributing more than the bare minimum during good economic times. This, in turn, could make the funded status of pension plans even worse.

Instead of this counterproductive approach, the UAW urges the Finance Committee to modify the existing rules regarding credit balances on a prospective basis, so that employers are required to value new credit balances according to the actual market performance of the extra amounts contributed by the employer. This would eliminate problems that have arisen when the actual market performance diverges from plan assumptions. But it would still preserve the important incentive that credit balances provide for employers to contribute more than the minimum required under the funding rules.

The UAW also supports increasing the deduction limit from 100 percent to 130 percent of current liability. This would allow employers to contribute more during good economic times, and to build up a bigger cushion to help during economic downturns.

In addition, the UAW supports modifying the current rules on the use of excess pension assets, so that employers are allowed to use these assets for health care expenditures for active and retired employees, not just for retirees. This would provide yet another incentive for employers to better fund their pension plans during good economic times, by providing greater assurance that companies can always benefit economically from surplus pension assets.

(D) Limits on benefits

The UAW strongly opposes the administration's proposals to place strict, arbitrary limits on benefits provided by pension plans that are less than 100 percent funded. These proposals would have a sharply negative impact on workers and retirees. In effect, they would reduce the adequacy of retirement benefits provided by pension plans to tens of thousands of workers and retirees. We are particularly troubled by the administration's proposals to freeze benefit accruals, which would have an especially devastating impact on workers and their families.

The UAW is also outraged by the administration's radical proposal to prohibit pension plans from even offering plant-closing benefits. These types of benefits have been an important means of cushioning the economic impact of plant closings as companies struggle to reorganize. By making it possible for more workers to retire

with an adequate income, these benefits reduce the number of workers who have to be laid off and wind up drawing unemployment insurance and retraining benefits. It makes no sense, therefore, to prohibit plans from even offering this type of benefit.

The UAW also is concerned about the discriminatory impact of the administration's proposals on blue-collar workers and retirees covered under so-called flat-dollar plans. It is patently unfair to place restrictions on benefit improvements in flat-dollar plans where the parties simply attempt to adjust benefits in accordance with the growth in wages, but to allow the benefit improvements that occur automatically in salary-related plans for white collar and management personnel. In our judgment, any proposals should treat both types of plans in an even-handed manner.

Contrary to the impression created by the administration, current law does not allow employers and unions to "conspire" to increase benefits without regard to the funded status of a pension plan, and to then terminate the plan and dump these unfunded benefit promises onto the PBGC. By virtue of the 5-year phase-in rule, the PBGC may not fully guarantee all benefit improvements preceding a plan termination. Thus, so-called "death bed" benefit increases are not guaranteed and do not result in any increase in the PBGC's liabilities.

The UAW does recognize that pension plans that are less than fully funded have experienced problems with the payment of lump-sum distributions. In some cases, the payment of lump sums has drained assets from these plans, unnecessarily jeopardizing the continuation of the plans and the payment of benefits to other participants and beneficiaries. Thus, the UAW would support reasonable limitations on the payment of lump sums in such plans.

In addition, the UAW supports the enactment of a new "plan reorganization" process for under-funded plans in situations where the employer has filed for chapter 11 bankruptcy reorganization. We believe that this type of process could provide better flexibility in the adjustment of benefits and funding obligations, and thereby enable more companies in financial distress to continue their pension plans. This would be beneficial for the participants and beneficiaries because it would allow them to still have their pension plan and to keep some benefits that would otherwise be lost in the event of a plan termination. At the same time, this would be beneficial for the PBGC because it would require the employer to continue making some contributions to the plan and prevent the unfunded liabilities from being transferred to the PBGC. Employers would also benefit from this plan reorganization option because it would provide greater flexibility in adjusting benefits and funding obligations, so that continuation of the pension plan becomes manageable.

To make sure that this plan reorganization process is not abused, the UAW believes it should only be available to employers that have already taken the difficult step of filing for chapter 11 bankruptcy reorganization. Furthermore, the bankruptcy court should be empowered to approve benefit and funding modifications beyond those already permitted under current law only if they are approved by all of the stakeholders: that is, by the PBGC, the employer, and union (or, in the case of non-represented participants, an independent fiduciary appointed by the bankruptcy court). Finally, the permissible benefit modifications should be restricted to non-guaranteed benefits that would be lost anyway in the event of a plan termination. Permissible funding modifications should extend to 30-year amortization of existing unfunded liabilities.

The UAW believes that this type of plan reorganization process could be a powerful tool for enabling struggling employers to continue their pension plans, while protecting workers and retirees to the maximum extent feasible, and also reducing the exposure of the PBGC. This process could provide the flexibility that is needed to address different economic situations that are presented in chapter 11 cases, rather than the one-size fits all approach proposed by the administration.

(E) Cash balance plans

The UAW believes that traditional defined benefit pension plans are better for workers and retirees than cash balance plans. At the same time, we recognize that cash balance plans are better than defined contribution plans or no pension plan at all. In recent years, the UAW has negotiated cash balance plans to cover new employees at Delphi, Visteon and other auto parts companies. This recognizes the difficult economic situations facing domestic producers in this industry.

Unfortunately, the continuing legal uncertainty concerning cash balance plans is causing some employers to shift to defined contribution plans or not to offer any pension plan at all. This was vividly demonstrated by the recent announcement by IBM that it would only provide a defined contribution plan for future employees. This trend is disturbing, both because it is bad for the future retirement income se-

curity of workers and retirees, and because it could further undermine the premium base for the PBGC.

For these reasons, the UAW supports legislation to resolve the legal uncertainties surrounding cash balance plans, by making it clear that they are not per se a violation of age discrimination laws. We also support allowing greater flexibility for cash balance plans in setting interest credits. At the same time, in situations where a traditional defined benefit plan is converted to a cash balance plan, we believe reasonable transition relief should be provided to older workers who are near retirement. This combination of reforms would protect the legitimate retirement expectations of older workers, while at the same time allowing employers to remain in the defined benefit pension system (and continuing paying premiums to the PBGC) through the vehicle of cash balance plans.

II. PENSION BENEFIT GUARANTY CORPORATION (PBGC)

It is important, at the outset, to underscore that there is no "crisis" at the PBGC. As the administration has admitted, the PBGC has sufficient assets to pay all guaranteed benefits for many years to come (at least until 2020, and possibly longer). Thus, the reports about the PBGC's growing deficit should not create a stampede towards extreme, counterproductive proposals. Congress should approach this issue in a deliberative manner, and make sure that any remedies do not cause more harm to workers, retirees, employers and the defined benefit pension system.

There is no mystery about what has caused the PBGC to have a growing deficit. In the recent past the PBGC was projecting a significant surplus. But bankruptcies in the steel industry led to the terminations of a number of pension plans with the largest unfunded liabilities ever assumed by the PBGC. Now, bankruptcies in the airlines industry are threatening to result in plan terminations with even bigger unfunded liabilities. Thus, there is no dispute that the PBGC's deficit is directly attributable to the widespread economic difficulties and bankruptcies in the steel and airline industries.

Unfortunately, the administration has come forward with three dangerous and counterproductive proposals to address the PBGC's projected deficit. In our judgment, these proposals would unfairly punish workers and retirees. They would also punish employers who are already experiencing economic difficulties, leading to more bankruptcies and job loss, as well as more plan terminations. Moreover, these proposals would encourage employers to exit the defined benefit system, increasing the danger of even bigger pension liabilities being transferred to the PBGC.

(A) Premium increases

The UAW opposes the administration's proposal to drastically increase the flat premium paid by all sponsors of single-employer defined benefit pension plans from $19 to $30, and to index the premium for future increases in wages. We also oppose the administration's proposal to impose a huge increase in the variable-rate premium charged to employers that sponsor plans that are less than fully funded, and to have the amount of this variable-rate premium vary depending on the credit rating of a company.

First, the magnitude of these premium increases would impose significant economic burdens on many companies. This would be especially hard on companies that are already experiencing economic difficulties and on medium-sized and small businesses. It would also exacerbate the competitive disadvantage for many older manufacturing companies with large legacy costs.

Second, the change in the structure of the variable-rate premium—specifically, linking it to a company's credit rating—would have the perverse effect of punishing companies that are already in difficult economic situations. Again, this would exacerbate the competitive disadvantage facing many older manufacturing companies.

In light of these factors, the UAW believes the administration's premium proposals would be counterproductive. At a minimum, these proposals would encourage an exodus of employers from the defined benefit pension system. This could undermine the retirement income security of millions of workers and retirees. It would also narrow the premium base for the PBGC, and thereby increase its financial difficulties. In the end, there is a real danger that the PBGC and the defined benefit pension system could enter into a death spiral, with a constantly shrinking premium base and growth in the pension liabilities being transferred to the PBGC.

(B) PBGC guarantees

The UAW opposes the administration's proposals to cut the PBGC guarantees. These include freezing the guarantees when an employer files for chapter 11 bankruptcy, and effectively eliminating any guarantee for plant-closing benefits. These changes would unfairly punish tens of thousands of workers and retirees, reducing

their retirement benefits and leaving them with a sharply reduced standard of living.

It is important to emphasize that, under current law, workers and retirees often lose a portion of their benefits when a plan is terminated. Because of the 5-year phase-in rule and other limits, workers and retirees typically lose a portion of their benefits attributable to recent benefit improvements and certain early retirement benefits. The UAW believes that these benefit losses should not be made worse by further reductions in the scope of the PBGC guarantees.

(C) PBGC lien for unpaid contributions

The UAW opposes the administration's proposal to give the PBGC a lien in bankruptcy proceedings for any unpaid pension contributions. This would punish troubled companies and their retirees, and lead to more liquidations, lost jobs and lost retiree health benefits. It could also result in more plan terminations and even greater pension liabilities being transferred to the PBGC.

Companies do not lightly take the step of filing for chapter 11 bankruptcy. They do so only when they are experiencing significant economic difficulties and are unable to pay all debts when due. Chapter 11 bankruptcy, by definition, is a zero-sum situation. To the extent one creditor is given a higher priority or greater claim on the company's assets, this necessarily means that the other creditors will receive less.

Thus, granting the PBGC a lien against a company's assets for any unpaid pension contributions necessarily means that other creditors—lending institutions, suppliers and other vendors, and the workers and retirees—would recover less. This would inevitably trigger a number of counterproductive, harmful consequences.

First, lenders would be more reluctant to provide the financing that is critically important to ensuring the successful reorganization of companies in chapter 11 proceedings. Without this financing, there would be more liquidations and hence more job loss. Even worse, the negative ramifications on the lending community would extend to companies that have not yet filed for chapter 11 bankruptcy, but who are experiencing economic difficulties and are potential candidates for chapter 11. To protect themselves, lenders would be forced to charge higher costs to these troubled companies or even refuse financing. The end result could be more bankruptcies, and even more job loss.

Second, retirees would be particularly hard hit by any PBGC lien for unpaid pension contributions, since this would significantly reduce their ability to collect on claims for retiree health insurance benefits. In many of the chapter 11 cases where there is an under-funded pension plan, the single biggest group of unsecured creditors are the retirees with their claim for health insurance benefits. If the PBGC is given a lien for unpaid pension contributions, the practical result would often be that there are no assets left to provide any retiree health insurance benefits. Thus, the net result of increasing the PBGC's recovery would be to punish the retirees—the very people the PBGC was created to protect.

Third, other suppliers and vendors would also be negatively impacted by the granting of a lien to the PBGC for unpaid pension contributions. In many bankruptcies, this means that these other businesses would get a significantly reduced recovery for their claims. This could jeopardize their ability to continue in business, leading to a chain reaction of more bankruptcies and job loss.

Fourth, it is highly questionable whether the PBGC would ultimately benefit by being granted a lien for unpaid pension contributions. To the extent this proposal forces more companies to liquidate more quickly, there would be more plan terminations and even more pension liabilities transferred to the PBGC.

The PBGC already has significant leverage in bankruptcy proceedings because of the enormous claims it has for unfunded liabilities, and because of its ability to affect the timing and other aspects of plan terminations. There is simply no need to increase the PBGC's leverage, to the detriment of workers, retirees, employers, and the entire defined benefit pension system.

(D) A positive approach to strengthening the PBGC

Instead of the harmful, counterproductive proposals advanced by the administration, the UAW believes that the PBGC can be strengthened through a number of approaches that would protect the interests of workers and retirees, employers and the entire defined benefit pension system.

First, the UAW believes that the overall funding of pension plans can be strengthened through the reforms we have previously supported in Section I of this testimony. By taking steps now to improve the funding of pension plans, Congress can improve the security of benefits for workers and retirees, and also reduce the long-term exposure of the PBGC. These reforms can also encourage employers to con-

tinue defined benefit pension plans, while avoiding counterproductive burdens on employers who are experiencing economic difficulties.

Second, the UAW believes that the plan reorganization process discussed previously in Section I of this testimony can be especially helpful in reducing the number of bankruptcy cases that lead to pension plan terminations and liabilities being transferred to the PBGC. In particular, we believe this type of process could be important immediately in providing the flexibility necessary for United and other airlines to continue their pension plans, instead of terminating them. This would significantly reduce the PBGC's deficit, by keeping these airline pension liabilities from being transferred to the PBGC. It would also benefit the workers and retirees at these airline companies, by keeping their pension plans going and allowing them to receive greater benefits than they would if the plans were terminated. At the same time, this reorganization process could provide significant economic relief to the troubled airlines, while still requiring them to continue some level of pension contributions. The same combination of factors could also make this type of reorganization process helpful in other industries, thereby reducing the PBGC's future exposure for pension liabilities.

Third, the UAW believes that the best way to deal with the steel and airline pension liabilities that have already or will soon be assumed by the PBGC is to have the Federal Government finance these liabilities over a 30-year period. This could be accomplished by having the Federal Government (or the PBGC) issue 30-year bonds, and then have the Federal Government pay the interest on these bonds as it comes due. We believe this approach would cost the Federal Government about $1–2 billion per year, depending on the magnitude of the airline pension liabilities that are ultimately assumed by the PBGC.

The UAW recognizes that the Federal Government is already running substantial budget deficits. But this infusion of Federal funds to strengthen the PBGC can easily be afforded by our Nation. For example, in its current budget, the administration has proposed significant increases in the amounts that individuals can contribute to various individual retirement and savings accounts (so-called RSAs and LSAs). This involves a substantial tax expenditure that will flow overwhelmingly to upper income individuals. The Congressional Research Service has estimated that this proposal will cost the equivalent today of $300 to $500 billion over 10 years. The UAW submits that these funds could better be used to strengthen the PBGC and protect the retirement benefits of average working families in defined benefit pension plans.

Whatever the difficulties, the fact remains that using general revenues to gradually finance the PBGC's steel- and airline-related pension deficit is better than all of the other options currently being considered. Specifically, it is better than punishing workers and retirees by cutting the PBGC guarantees. It is better than punishing companies that sponsor pension plans by drastically increasing their PBGC premiums. And it is better than punishing companies that are experiencing financial distress by giving the PBGC a greater claim in bankruptcy proceedings. These other options will inevitably hurt workers and retirees and employers that sponsor pension plans. They will also lead to more bankruptcies and job loss. And they will drive employers away from the defined benefit pension system, creating a death spiral for the PBGC.

The truth is the PBGC was never designed to handle widespread bankruptcies and pension plan terminations across entire industries, as we have seen in steel and are now witnessing in airlines. Indeed, the seminal case that led to the creation of the PBGC was the Studebaker situation, in which a single auto company went out of business and terminated its pension plan. Obviously, the entire auto industry did not go bankrupt or terminate its pension plans then.

When the PBGC was created by Congress, it was modeled after the Federal Deposit Insurance Corporation (FDIC), which insures bank deposits for individuals. The FDIC was designed to handle isolated bank failures, not the collapse of a broad section of the banking industry. When the savings and loan crisis occurred in the 1980s, Congress wisely recognized that the costs associated with S&L failures should not be shifted onto the backs of individual depositors, nor onto the backs of other banking institutions. Congress recognized that those alternatives would impose unacceptable hardships on individuals and other banks, and would have a counterproductive impact on the rest of the banking system and our entire economy. As a result, Congress decided to have the Federal Government finance the S&L liabilities over many years, at a cost of hundreds of billions of dollars.

The same principles make sense in the case of the steel and airline pension liabilities that have or will be assumed by the PBGC. Shifting those costs onto workers and retirees or employers that sponsor pension plans would simply lead to unacceptable hardships and counterproductive economic consequences. The best approach—for workers and retirees, for employers that sponsor pension plans, for troubled com-

panies and for our entire economy—is to spread those costs gradually and broadly across society by having the Federal Government finance them over 30 years.

This approach would not reward "bad actors." The steel and airline bankruptcies and pension plan terminations were caused by many factors, including the policies (or non-policies) of the Federal Government relating to trade, deregulation, energy and health care, as well as the shocks flowing from the terrorist attacks on September 11th. In our judgment, it is entirely appropriate to now ask the Federal Government to help pay for the pension costs flowing from those policies and events.

Indeed, Congress and the Finance Committee already have endorsed this notion in a more limited context. In the Trade Act of 2002, Congress provided for a new 65-percent tax credit to pay for retiree health benefits for retirees whose pension plans have been terminated and taken over by the PBGC, and who are between the ages of 55–65. Through this provision, Congress effectively used general revenues to pay for part of the costs associated with providing retiree health benefits to this group of retirees. This provision was designed primarily as a response to the bankruptcies (and pension plan terminations) in the steel industry, which had resulted in thousands of steelworker retirees losing their health benefits. It reflected a recognition by Congress that our trade and health care policies had played a role in the steel company bankruptcies and the loss of retiree health benefits. The UAW submits that the same principles now justify using general revenues to pay for the pension costs flowing from the steel and airline bankruptcies and plan terminations.

Similarly, Congress has a long history of using general revenues to respond to disasters across our Nation. This includes floods, hurricanes, droughts and many other types of catastrophes. The UAW submits that the devastation that has occurred in our steel and airlines industries is no less worthy of Federal assistance.

There is no danger this type of approach will create a "moral hazard" leading to worse pension funding and more problems in the future. This is because the UAW is proposing that the infusion of general revenues to pay for the airline and steel pension liabilities be coupled with the package of reforms to strengthen the funding of other pension plans and with the new plan reorganization process that will help troubled companies to continue their pension plans and reduce the future exposure of the PBGC.

CONCLUSION

The UAW appreciates this opportunity to testify before the Finance Committee to express our views on the administration's proposals relating to the funding of pension plans and the financial stability of the PBGC. We urge the committee to reject the administration's harmful and counterproductive proposals, and instead to fashion a constructive package that will strengthen the funding of pension plans, protect workers and retirees, provide stability and predictability to employers that sponsor pension plans and encourage them to remain in the defined benefit pension system, and place the PBGC on a sound and sustainable path.

We look forward to working with members of the Finance Committee as you consider these important pension issues. Thank you.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: I would like to follow up on your idea about reorganization.

(a) What kind of compromises would you expect through the reorganization process?

(b) Would the idea work pre-bankruptcy?

Answer: (a) Under current law, when a company has filed for chapter 11 bankruptcy, the bankruptcy court is limited to the options of freezing or terminating the pension plan. The UAW believes it would be better to give the bankruptcy court more flexibility to approve plan funding and benefit modifications that have been worked out by all of the stakeholders (the PBGC, the company, and the union or representative of non-organized workers and retirees). This could lead to plan modifications that would be in between the options of freezing or terminating the plan. For example, it could lead to non-guaranteed benefits being scaled back or eliminated, and funding obligations being extended over a lengthy (*e.g.,* 30-year) time period.

The PBGC would obviously benefit if the plan is continued in this manner, since no liabilities would be transferred to the PBGC. Also, the unfunded liabilities would be reduced if some non-guaranteed benefits are cut, and the employer is still required to make some level of contributions.

The workers and retirees would benefit by having their plan continued, rather than being terminated. Even though some non-guaranteed benefits might be lost,

the reorganization process might accomplish this in a fairer and more flexible manner than would termination.

Finally, the company could also benefit, since the continued funding obligation would be less than that required under a freezing of the plan (because of the longer funding period and the reduction or elimination of some benefits). This lesser funding obligation might be preferable to a company than the negative cash flow consequences that could result if the plan is terminated and the PBGC immediately pursues its claim for the entire unfunded pension liability.

(b) The UAW does not believe the plan reorganization process should be available pre-bankruptcy. This would open up the possibility of abuse by employers who might try to use the process simply to get rid of certain pension benefits. By providing the reorganization process only in bankruptcy situations, Congress can ensure that this process is only used in cases where the employer is genuinely in financial difficulty. In addition, this would ensure that the neutral bankruptcy court oversees the reorganization process. We do not believe it is appropriate to allow any of the stakeholders—and especially the PBGC—to unilaterally control the process, since that would unfairly skew the outcome towards the interests of that particular stakeholder.

Question: Do you think that if the administration's proposals were enacted, the UAW would push for higher contributions to their defined benefit plans?

Answer: The UAW has already pushed for higher contributions by companies to our negotiated pension plans. For example, in the early 90s we pushed for General Motors to increase funding to its pension plan.

Unfortunately, we do not believe the administration's pension proposals would encourage bargaining for higher pension contributions. Rather, we are deeply concerned that the net result of these proposals would be to punish older manufacturing companies, by imposing sharply higher and more volatile pension funding and premium requirements on them. This could exacerbate the competitive disadvantages they already face because of heavy legacy costs. This in turn could lead to more plant closings and even trigger bankruptcies. The end result could be more lost jobs and benefits, and even more plan terminations with even greater liabilities being transferred to the PBGC. Also, we are concerned this could trigger an exodus of employers from the defined benefit pension system, which would harm workers and retirees and possibly result in a death spiral for the PBGC as well as what is left of the defined benefit pension system.

Response to a Question From Senator Hatch

Question: Mr. Reuther, you mentioned in your testimony that UAW believes that traditional defined benefit pension plans are better for workers and retirees than cash balance plans. Many experts believe that cash balance plans are superior to traditional DB plans for many workers, including younger employees and those in high technology industries. Does the UAW really believe that cash balance plans are inferior in every case, even for your younger employees who might not spend their entire lives in one company?

Answer: In industries where workers tend to stay with a single-employer for most of their working careers, the UAW believes that traditional defined benefit pension plans are the best vehicle for providing workers with a stable and adequate retirement income. Traditional defined benefit plans provide workers with a lifetime stream of specific monthly benefits. These plans can also provide early retirement, disability and other types of pension benefits to address the needs of working families.

The UAW recognizes that in industries where employees only stay a short time with a single company, cash balance plans may be a better means of providing retirement income to workers than defined contribution plans. Certainly, cash balance plans are better than no pension plan at all. That is why the UAW supports legislation to resolve the legal uncertainties surrounding cash balance plans, by making it clear that they are not per se a violation of age discrimination laws.

Prepared Statement of Hon. John D. Rockefeller IV

Mr. Chairman, thank you very much for holding this hearing. Congress has important work to do this year updating the laws that govern our defined benefit pension plan system. My own hope is that we can find a way to make the system more sound, protect workers' promised pensions, and encourage employers to continue to provide these valuable benefits. I have some serious concerns about whether

changes the administration has proposed represent true progress toward those goals.

Less than 20 years ago, there were more than 130,000 defined benefit plans offered to workers around the country. Because many employers have shifted toward defined contribution plans, under which workers and retirees bear more risk, there are now fewer than 35,000 traditional pension plans in operation. This worries me because I understand how important the guarantee of a defined benefit pension can be.

I stand ready to work with my colleagues on this committee and the administration in crafting reforms to the pension system that will guarantee adequate funding of pension plans and provide appropriate premium revenue to the Pension Benefit Guaranty Corporation which insures those plans. However, I am concerned that many of the changes suggested by the administration might impose such unreasonable burdens on plan sponsors that employers will decide to leave the system.

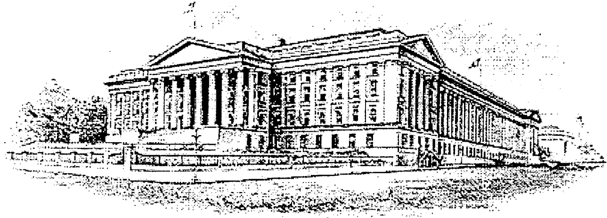
The administration has proposed a yield curve that will dramatically increase the liability calculation of many industries with older workers. The yield curve also introduces uncertainty, complexity, and volatility to the liability calculation—all anathema to companies focused on the bottom line. Even for entirely healthy plans, the administration has proposed dramatically increasing the premium payments, making defined benefit pensions more expensive to maintain. I also expect to hear considerable objection from companies to the notion of their pension liability calculations being determined by the whims of credit rating agencies which operate with extremely little oversight.

I am concerned that all of those factors will make defined benefit pension plans less attractive for employers. But my greatest concern with the administration's proposal has to do with the increased risk it imposes on employees who are working hard and holding up their end of the bargain. The administration proposes to punish workers for the sins of management. That is, benefit increases and benefit accruals will be frozen for workers whose companies under-fund pension plans. Such a rule may actually create an incentive for management to under-fund pension plans, eliminating hard-won benefits for employees. Certainly, employees do not have the authority to direct the manner in which employers fund plans.

Finally, I am very concerned that the administration has made no proposal to address the pension crisis in the airline industry. A considerable amount of the deficit facing the PBGC is expected to derive from failing airline pension plans. Yet the administration has proposed no remedies specific to that industry that would help airlines maintain their plans. Given the PBGC's potential exposure to large liabilities associated with airline pensions, it is difficult to take seriously any reform proposal that ignores this industry's situation.

I look forward to hearing the testimony of the witnesses today. I hope that they will address some of the concerns I have outlined. And again, Mr. Chairman, I appreciate your holding this hearing to kick off this committee's important work on pensions.

PREPARED STATEMENT OF HON. MARK J. WARSHAWSKY



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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

Good afternoon Chairman Grassley, Ranking Member Baucus, 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. In my testimony, I will focus on the proposal's funding rules, in particular, the calculation of the funding targets.

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, ultimately the insurance system will simply not have adequate resources to pay all the benefits that it owes to the one million workers and retirees currently owed benefits who were participants of failed plans and to the beneficiaries of plans that fail in the future.

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. The cause of the financial problems is 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. Minor tinkering with existing rules will not be sufficient. If we want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system to make it financially sound.

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. These unfunded benefits are costly both to participants because many lose benefits and also to other pension sponsors because, they are likely bear the higher costs that such underfunding imposes on the insurance system through even higher premiums.

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. 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. The current 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 as a result will moderate future insurance costs that will be borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding. We have

proposed a fundamental reform of the treatment of defined benefit pension plans, one that we believe will change plan sponsor behavior, ultimately result in better funded and better managed defined benefit pension plans, and secure benefits for workers and retirees.

The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target – a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be required to fund-up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

Some key features of the proposed funding rules:

- *Funding based on meaningful and accurate measures of liabilities and assets.* The proposal provides funding targets that are based on meaningful, timely, and accurate (using the yield curve for discounting is a central component of this proposal) measures of liabilities that reflect the financial health of the employer.

- *Accrued benefits funded.* Sponsors that fall below minimum funding levels will be required to fund up within a reasonable period of time. The proposal requires a 7-year amortization period for annual increases in funding shortfalls. There will be restrictions on the extension of new benefit promises by employers whose plans' funded status falls below acceptable levels. Benefit restrictions will limit liability growth as a plan becomes progressively underfunded relative to its funding target.

- *Plan sponsors able to fund plans during good times.* Many believe that the inability of plan sponsors to build sufficiently large funding surpluses during good financial times under current rules has contributed to the current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. And every plan will be allowed to fund to a level of funding corresponding to the total cost of closing out the plan. Under our proposal, allowing plan sponsors the opportunity to prefund and therefore limit contribution volatility is a critical element.

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. In addition, plan sponsors have frequently voiced their dislike of volatile and unpredictable minimum contributions.

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.

Moreover, the Administration recognizes that the current minimum funding rules -- particularly the deficit reduction contribution mechanism and the limits on tax deductibility of contributions -- have contributed to funding volatility. Our proposal is designed to remedy these issues; for example, we increase the deductible contribution limit. We feel this additional ability to fund during good times, combined with other provisions of the proposal; for example, increasing the amortization period to seven years compared to a period as short as four years under the current law deficit reduction contribution mechanism, together with the existing freedom of plans have to choose pension fund investments, will give plans the tools they need in order to smooth contributions over the business cycle. Plans may choose to limit volatility by choosing an asset allocation strategy or conservative funding level so that financial market changes will not result in large increases in minimum contributions. These are appropriate methods for dealing with risk; it is inappropriate to limit contribution volatility by transferring risk to participants and the PBGC.

Meaningful and Accurate Measures of Assets and Liabilities

We propose measuring liabilities on an accrual basis using a single standard liability measurement concept that does not distort the measures by smoothing values over time. Within the single method, liability is measured using assumptions that are appropriate for a financially healthy plan sponsor (investment grade credit rated), and alternatively using assumptions that are appropriate for a less healthy plan sponsor (below investment grade) that is more likely to find itself in a position of default on pension obligations in the short to medium term.

On-going 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.

The at-risk liability measure estimates the liabilities that would accrue as a plan heads towards termination because of deteriorating financial health of the plan sponsor. At-risk liability would include accrued benefits for an ongoing plan, plus increases in costs that occur when a plan terminates. These costs include acceleration in early retirement, increase 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, assets will be valued based on market values on the valuation date for determining minimum required and maximum allowable contributions. 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 use of a 30-year Treasury rates for purposes of 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]

An Example of Discounting Liabilities Using the Yield Curve

Today, I'll provide an example (economists call this a stylized example) of how the yield curve would be used in discounting pension obligations. The yield curve is used to discount the plans aggregate expected pension payments in each year to participants. The plan administrator has calculated these future pension payments based on the plan's formula for benefits that participants have earned up to the valuation date. As this example shows, once the actuary has determined the plan's annual cash benefit payments summed over all participants in a manner similar to what is done under current law, discounting those payments using the yield curve is quite simple.

Our hypothetical plan consists of three individuals, the 64-year-old Mr. Brown, the 59-year-old Ms. Scarlet, and the 54-year-old Mr. Green. Each of the three retires at age 65 and receives the same pension benefit payment each year until death at age 80. The benefit Mr. Brown has earned to date is higher than Ms. Scarlet's (it is assumed that he has been working longer under the plan) whose expected benefit is in turn larger than Mr. Green's. Mr. Brown's annual benefit under the plan is $12,000, Ms. Scarlet's is $9,000 and Mr. Green's is $6,000.

Chart 1 shows the AA corporate bond yield curve that would be used to discount these benefit payments. The yield curve has interest rates for years 0 to 80. For our stylized example we will only need to use points for the years 1 through 26 because we assume that no participant will draw benefits before year 1 and all payments will be made by year 26. The example applies the yield curve to payments made each year.

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[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.

Chart 1

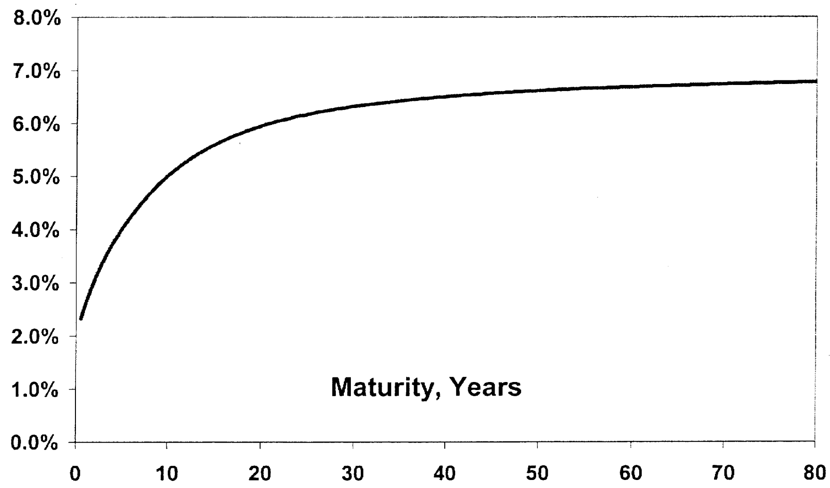


Chart 2 shows the benefit payments that each participant is expected to receive in the future. Chart 3 shows expected total payments that will be made by the plan each year in the future; this is simply the sum of payments to the three individual participants. The total benefit line takes an upward step each time a participant retires and a downward step each time a participant's benefit ends.

Chart 2

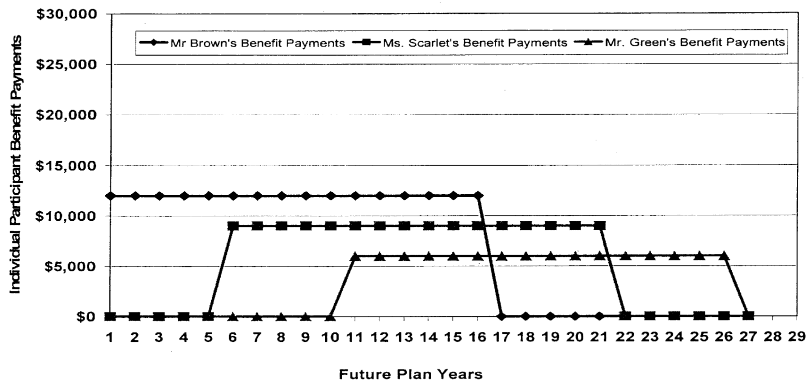
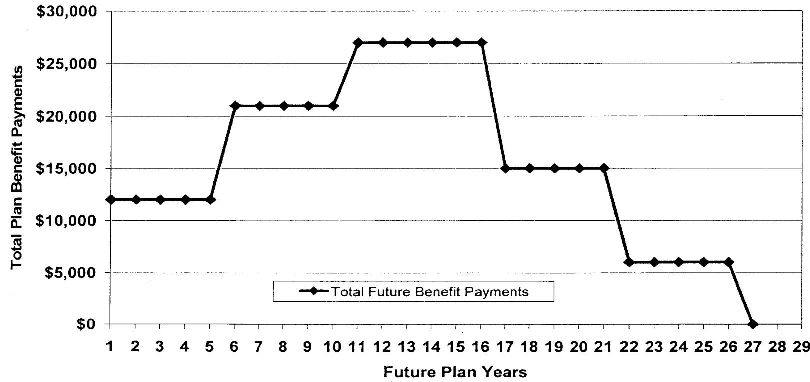


Chart 3



How do we apply the yield curve to discounting these benefit payments?

Let's take years 5, 14 and 20. In year 5, the plan expects to pay $12,000 in benefits, all to Mr. Brown. The discount rate for that year drawn from the yield curve is 4.03 percent. To compute the present value of the $12,000, the $12,000 is divided by 1.218 (one plus the interest rate expressed in decimal form, 1.0403, raised to the 5th power), which equals $9,849.

For plan year 14 the expected benefit payments are $27,000 ($12,000 to Mr. Brown, $9,000 to Ms. Scarlet and $6,000 to Mr. Green) and the yield curve interest rate is 5.51 percent. To compute the present value, the $27,000 is divided by 2.119 (1.0546 taken to the 14th power) yielding $12,742. For year 20, the plan expects to pay $15,000 ($9,000 to Ms. Scarlet and $6,000 to Mr. Green) and the discount rate from the yield curve is 5.96 percent. Dividing $15,000 by 3.183 gives a present value of $4,713. Note that even though there are three participants in the plan, once their benefit payments during any period are added together only one interest rate is needed to compute the present value for that period. Separate interest rates are not used for every individual participant in the plan.

In order to compute the plan's target liability the plan needs to perform computations like the one above for each payment period from 1 through 27 and sum them together. The liability for this hypothetical plan is $238,994. In this example, only 26 interest rates are used, one for each year that benefit payments are made. Even if our hypothetical plan had thousands of participants, but payments were made for only 26 years in the future, only 26 interest rates would be needed to compute the plan's liability.

This is, of course, a simplified example. The plan actuary needs to make a number of computations and use his or her professional judgment to determine the plan's future benefit payments each year: the actuary must estimate the probability that a participant will retire at a particular time in the future and must model the probable pattern of payments that will be made for that participant until the participant's death. These computations, already required by current law, are complex, but once the actuary has determined the annual cash benefit payments, discounting those payments using the yield curve is quite simple and can easily be done using a basic spreadsheet program.

As noted above, if Mr. Brown elected to take a lump sum payment rather than an annuity, the minimum value of that lump sum would also be computed using the yield curve. We have assumed that Mr. Brown will begin receiving his annual benefit of $12,000 next year and will receive the same benefit for 16 years. In order to compute the value of those future payments as a lump sum we would simply discount each period's cash flows using interest rates drawn from the yield curve to find the present value of the benefit in each future period. Then we sum those present values together to yield the minimum lump sum value. In year one, for example, the interest rate drawn from the yield curve is 2.59 percent. If the first $12,000 payment is made one year in the future its present value would be $11,697. The present value of the payment made in year 5 would be computed using the year 5 point on the yield curve that is 4.03 percent. Its present

value would be $9,849. In year 12, the interest rate used to compute the present value is 5.29 percent and therefore the present value of the benefit payment is $6,465. In total, Mr. Brown's hypothetical lump sum would be valued at $131,035.

Distinction by Credit Rating

Under the Administration's proposal, the appropriately measured accrued liabilities serve as the plan funding targets. The target funding level for minimum required contributions will vary depending on the financial health of the plan sponsor. Plans sponsored by financially healthy firms (investment grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below investment grade rated) will use 100 percent of at-risk liability as their funding target.[2]

The goal of pension funding rules is to minimize benefit losses to plan participants. When pension plans default on their obligations, the PBGC is required to make benefit payments to plan participants subject to the guarantee limits. Ultimately, if plan defaults are too numerous, the insurance system will collapse and taxpayers may be called upon to fund the pension promises. Pension plans sponsored by firms with poor credit ratings pose the greatest risk of such defaults. Therefore, it is only natural that pension plans with sponsors that fall into this readily observable high risk category should have more stringent funding standards. The at-risk liability measure is an appropriate funding target for below investment grade companies because the target reflects the plan liabilities that would accrue as a plan heads towards termination.

The table below shows the average cumulative default rate of corporate bond issuers as computed by Moody's Investor's Service (January 2005). This table indicates that, over time, below investment grade firms have a substantially higher likelihood of default than investment grade firms. The table indicates that 14.81 percent of Ba rated firms (just below investment grade) experience a default within 7 years, whereas only 3.12 percent of Baa rated firms (just above investment grade) experience a default within the same period.

[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.

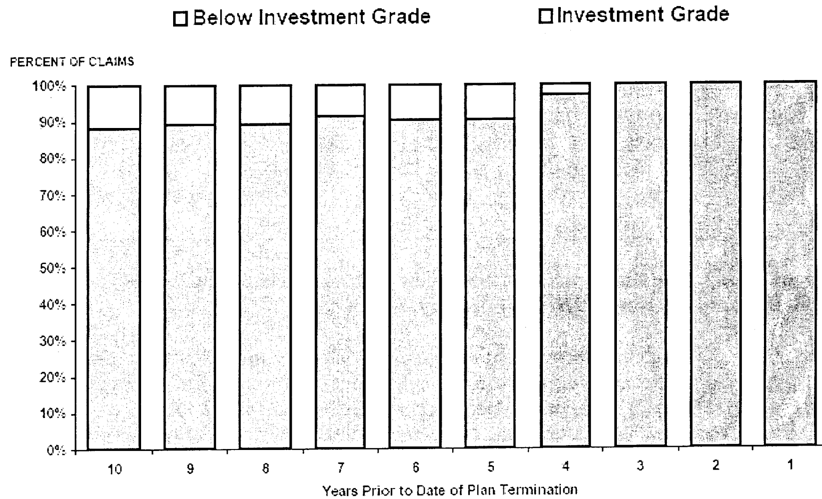
Average Cumulative Default Rate by Credit Rating, 1970-2004
Selected Data

Years	*Moody's Credit Rating*						
	Aaa	Aa	A	Baa	Ba	B	Caa-C
1	0.00	0.00	0.02	0.19	1.22	5.81	22.43
3	0.00	0.03	0.22	0.98	5.79	19.51	46.71
5	0.12	0.20	0.50	2.08	10.72	30.48	59.72
7	0.30	0.37	0.85	3.12	14.81	39.45	68.06
10	0.63	0.61	1.48	4.89	20.11	48.64	76.77
15	1.22	1.38	2.74	8.73	29.67	57.72	78.53
20	1.54	2.44	4.87	12.05	37.07	59.11	78.53

Source: Moodys Investor Services, Global Credit Research, Default and Recovery Rates of Corporate Bond Issuers, 1920-2004, January 2005.

The following chart shows that firms generally have a below investment grade credit rating for several years prior to their plan default on pension obligations triggering a claim on the PBGC. This shows 27 largest claims to PBGC for which the series of S&P ratings were available. This suggests that while defaults are certainly not easily predictable (many other plans with below investment grade credit ratings did not default), these are clear warning signs that any responsible regulatory system should take into account. Differentiating funding targets based on credit ratings is appropriate and the investment grade/below investment grade distinction is the most useable and accurate breakpoint.

Chart 4
Debt Ratings for 27 Large PBGC Claims



Source: PBGC

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 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] This description draws on the description in the Treasury Blue Book.

It is critical to note that while our proposal does away with "credit balances" as currently construed, it does not reduce the incentives to contribute above the minimum. It does, however, prevent underfunded plans from using credit balances for funding holidays. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have resulted in plans having lengthy funding holidays, while at the same time becoming increasingly underfunded. Just marking credit balances to market is not sufficient to solve the problem if underfunded plan are still able to take funding holidays. In the Administration proposal, the focus of the reformed funding rules on stocks of assets and accrued liabilities means that pre-funding pays off in a reduction in future required minimum payments. Under a reformed set of funding rules, pre-funding adds to a plan's stock of assets, thereby reducing any current shortfalls or the likelihood of potential future shortfalls relative to appropriately and accurately measured liabilities.

An Example of Funding Rules

Using another example we can demonstrate how minimum contributions would be determined under the funding proposal. Liabilities for the plan are computed over a five-year period using the cash flows and the yield curve depicted in the graphs above. (For simplicity, it is assumed that the yield curve interest rates remain constant over the five-year period.) We then begin with an arbitrarily chosen level of plan underfunding to demonstrate how the amortizations of plan deficits would work. For this example, we simplify and assume that the interest rate charged for amortization of shortfalls is zero. That means that a shortfall increase payment amortized over 7 years is merely the increase divided by 7. The normal cost is also assumed to be zero to simplify the exposition.

In year one, the plan is underfunded by $18,994. That means that the plan must contribute a minimum of $2,713, which is the amortization payment for $18,994 over a seven year term -- in year one and for the next six years -- unless the plan becomes fully funded before year seven.

In year two, the plan's funding deficit is $8,000 as a result of increases in both the value of assets and liabilities. Since this new shortfall is less than the value of future contributions (we assume that the plan will make future contributions so their present value effectively becomes an asset) the increase in the shortfall is zero. Under the amortization rules no *new* payment is required; because the plan is still underfunded, however, a second payment of $2,713 must be made. The amortization rule is designed to encourage plans to fund up quickly in order to protect participants' pensions. For that reason, the amortization payment of $2,713 is not reduced even though the plan's funded status has improved.

In year 3, the funding shortfall increases to $18,367 because the value of assets has fallen. Because this is $4,800 more than the value of the remaining amortization payments, a new payment of $686 is added to the existing payment of $2,713 meaning that total contributions are $3,399 in year 3.

In year 4, because of an increase in asset values, the plans deficit falls to $9,283. This is less than $14,968, the value of the remaining shortfall payments from year 1 and year 3 so there is no new payment and the required contribution remains $3,399.

In year 5, asset values rise again and the plan is now fully funded. Because the plan no longer has a funding deficit, no minimum contribution is required and all past amortization payments are cancelled.

Table 2
Minimum Funding Example

Year	1	2	3	4	5
Assets	**$220,000**	**$242,000**	**$225,060**	**$236,313**	**$250,492**
Liabilities	**$238,994**	**$250,000**	**$243,427**	**$245,596**	**$247,656**
Shortfall	**$18,994**	**$8,000**	**$18,367**	**$9,283**	**$0**
Value of Remaining Year 1 Pmts.		$16,281	$13,567	$10,854	$8,140
Value of Remaining Year 2 Pmts.			$0	$0	$0
Value of Remaining Year 3 Pmts.				4,114	3,429
Value of Remaining Year 4 Pmts.					$0
Value of All Remaining Payments	$0	$16,281	$13,567	$14,968	$11,569
Shortfall Increase	**$18,994**	**$0**	**$4,800**	**$0**	**$0**
Minimum Contribution for:					
Year 1 Shortfall Increase	$2,713	$2,713	$2,713	$2,713	$0
Year 2 Shortfall Increase		$0	$0	$0	$0
Year 3Shortfall Increase			$686	$686	$0
Year 4 Shortfall Increase				$0	$0
Year 5 Shortfall Increase					$0
Total Minimum Contribution	**$2,713**	**$2,713**	**$3,399**	**$3,399**	**$0**

Benefit Restrictions

Finally, we have proposed benefit restrictions that will limit liability growth as a plan becomes progressively underfunded relative to its funding target. It is important to arrest the growth of liabilities when plans are becoming dangerously underfunded in order to ensure that plan participant will collect benefits that they accrue. Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in many situations even make benefit improvements. Plan sponsors in financial trouble have an incentive to promise 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. To guard against this type of moral hazard, if a company's plan is poorly funded, the growth in the plan's liabilities should be limited unless and until the company funds them, especially if the company is in a weak financial position.

Plan sponsors able to fund plans during good times

The Administration proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. The importance of these mechanisms that I have described is not simply to force plans to fund-up quickly and reduce the rate at which new obligations accrue. Their importance is also that rational, forward looking managers will respond to these reforms by taking steps to ensure that plans remain well funded on an ongoing basis. The Administration plan matches new responsibilities, to more fully fund pension obligations, with new opportunities – an enhanced ability to pre-fund obligations on a tax preferred basis.

Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed significantly to current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. Every plan will be allowed to fund to at least at-risk Liability.

The first cushion is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability values fluctuations that occur over a business cycle. Plan sponsors would also be able to build a second funding cushion that allows them to pre-fund for salary or benefit increases.

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 detailed discussion of some of the critical elements of the proposal. My colleagues and I are available and look forward to discussing the proposal and the motivations for the proposal and answering any additional questions you may have.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: Your funding proposal would appear to severely limit contributions in times of high interest rates, which would seem to create sizable minimum contribution requirements when rates start to fall. Have you done modeling on the impact of your proposal on contribution requirements in an interest rate environment where rates have peaked and are headed down, like the mid-1980s? If so, please describe the results.

Answer: We are concerned that some of those testifying as to the impact of the maximum deductible contribution amount did not fully understand how expansive our proposal is. The level up to which firms may make deductible contributions has two cushions, not just one as has been cited:

- first, to 130 percent of the plan's funding target, and
- second, an increase to reflect how much larger the funding target would be if it were to take into account anticipated future salary and benefit increases.

In addition, every plan will be allowed to fund at least to at-risk liability.

We have modeled a wide range of economic environments. This modeling indicates that the funding cushions are more than adequate to allow sponsors that fully utilize the additional funding opportunities to not see their plans become under-funded solely as a result of asset and liability value fluctuations that occur over a business cycle. Please see the White Paper on PBGC's website at *http://www.pbgc.gov/publications/white_papers/wp_040605.pdf* for a full discussion of PBGC's modeling.

Question: You commented that there are two problems with the current credit balance structure: the failure to credit actual investment returns and the availability of contribution holidays for under-funded plans. Would crediting actual investment gain or loss to credit balances address your concerns? What about actual rates of return plus limiting application of the credit balance to amortization bases, not normal cost?

Answer: Because credit balances currently are not marked to market and can be used by under-funded plan sponsors, they have, in many cases, resulted in plans having lengthy funding holidays, while becoming increasingly under-funded. This was the case in several of the pension insurance program's largest losses to date, such as Bethlehem Steel. It is critical to note that just marking credit balances to market is not sufficient to solve the problem if under-funded plans are still able to take funding holidays.

Though our proposal does away with "credit balances" as currently construed, it preserves incentives to contribute above the minimum. Because the administration's proposed funding rules focus on the level of assets and accrued liabilities, pre-funding pays off in a reduction in future required minimum payments. Pre-funding adds to a plan's assets, thereby reducing any current shortfalls or the likelihood of potential future shortfalls relative to appropriately and accurately measured liabilities.

Question: Your proposal determines the yield curve with a 90-day averaging period. Since the yield curve does not have a constant shape, is there an upper limit on the averaging period that generates a meaningful yield curve? For example, if Congress decided the averaging period should be 2 years, would you still recommend a yield curve instead of a single rate?

Answer: I would be very concerned about an averaging period of 2 years, regardless of whether the yield curve concept was implemented or not. As I discuss in my testimony, smoothing asset or liability values over time masks economic reality. My view is that there are significant risks associated with masking the underlying financial and economic reality of under-funded 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 90-day period was chosen in order to remove interest rate "noise"—short-term fluctuations—that sometimes occurs over brief time periods. Our research suggests that 90 days works well for this purpose.

RESPONSES TO QUESTIONS FROM SENATOR BUNNING

Question: I have always felt strongly that we needed to make changes to the funding rules in order to encourage companies to make higher contributions during good economic times in order to help to ride out later tougher periods. I was pleased to see that the administration has addressed this issue in your recent proposals. Can you comment for me on the details of your proposal—particularly why you think your proposal is better than other ideas to address this issue, such as raising the allowable deductible contribution under the current rules from 100 percent of current liability to a higher percentage such as 125 percent or higher?

Answer: The administration proposal does include a provision that will increase the limit on deductible contributions. The proposal creates two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax-deductible contributions. In addition, every plan will be allowed to fund at least to at-risk liability.

The first cushion is designed to allow firms to build a sufficient surplus so that plans do not become under-funded solely as a result of asset and liability values fluctuations that occur over a business cycle. This cushion allows funding to 130 percent of the funding target.

Plan sponsors would also be able to build a second funding cushion that allows them to pre-fund for salary or benefit increases.

We believe that for most plan sponsors, the administration provides as much, and likely more, pre-funding flexibility than the alternative you describe. We would be happy to discuss this issue with you in more detail.

Question: As you know, one issue we have seen is the effect that an unexpected number of lump-sum distributions can have on the health of a plan. Can you comment on the administration's plans for addressing this issue of lump-sum distributions?

Answer: The proposal contains three measures to combat this problem. First, it requires plans offering lump-sum payment options to account for future lump-sum payments when calculating their liabilities.

Second, seriously under-funded pension plans would not be able to make lump-sum distributions under our proposal. Lump sum prohibitions would apply to plans with financially weak sponsors that are 80 percent or less funded, and plans with financially healthy sponsors that are 60 percent or less funded. This will protect plan assets for participants who are not eligible for retirement or who prefer to receive an annuity.

Finally, under current law, the use of an inappropriately low discount rate for determining the value of lump sums creates an incentive for participants to choose lump sums. Under our proposal, the yield curve would be used to calculate minimum lump sums, which will eliminate this distortion that can bias a participant's payout decision toward lump sums. 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.

Question: As you well know, there has been much criticism from the business community and some unions regarding the yield curve that this committee passed last year, based on the administration's proposal, and its use in determining the applicable interest rate to value funding requirements. In particular, concerns have been raised about complexity, accuracy, and volatility, and it has been argued that the yield curve will hurt older manufacturing companies which have larger numbers of retirees and older workers. Could you please address these criticisms?

Answer: As I explain in my written testimony, implementing the yield curve is not complex. A simple numeric example included in that written testimony demonstrates how the yield curve can be used in computing pension liabilities.

We have seen no evidence that implementation of the yield curve will pose a difficult technical challenge for actuaries or that it will cause significant increases in pension plan expenses.

Current rules attempt to insulate pension plans from financial market realities through the smoothing of contributions, assets and liabilities. These rules were created in an attempt to reduce the year-to-year variation of sponsor pension contributions. Such smoothing has not only failed to accomplish this objective, but has created a set of perverse incentives that affect pension plans' funding and investment decisions. Artificial smoothing does not eliminate investment or under-funding risk for a sponsor, nor does it redistribute such risks through time. The sponsor that benefits from smoothing merely transfers these risks to other firms in the insurance system.

The administration takes the view that pension rules should provide plan sponsors with the tools to manage volatility, including amortization over 7 years and extra opportunity to pre-fund benefits in good times. The rules should encourage use of these tools as well as available financial market tools to reduce contribution volatility, rather than artificially smoothing asset and liability values and distorting current economic reality. In order to encourage such behavior, assets and liabilities will be measured on a current and accurate basis under the administration's proposal. Liabilities will be measured using a yield curve that matches appropriate market interest rates to the time structure of the pension plan's projected cash flows.

The administration proposal also raises the ceiling on deductible contributions. This will allow those plan sponsors to build funding surpluses in order to reduce contribution volatility.

Use of the yield curve is a critical element in accurate measurement of liabilities. Accurate measurement of liabilities does not in any way put any plans—including those with older workforces and high numbers of retirees—at a disadvantage. The pension benefit obligations that make up plan liabilities are not changed in any way by use of the yield curve. The yield curve simply recognizes that older plans must make a relatively high proportion of benefit payments in the near future. Conversely, use of the yield curve also recognizes that younger plans will make a high proportion of benefit payments in the more distant future. Current law, by using a single long-term bond rate to discount all future payments, largely ignores this fact and therefore measures liabilities inaccurately.

Questions about how the yield curve is computed are addressed in a white paper that appears on the Treasury website. The address for the white paper is: *http://www.treas.gov/offices/economic-policy/reports/pension_yieldcurve_020705.pdf.*

Question: As are others on this committee, I am obviously concerned about the state of our airline industry. Last year, some temporary relief was passed with regard to that industry's pension plans despite the concerns of some that those temporary measures may cause the PBGC to be faced with a higher liability in the event of an eventual PBGC takeover of some of these airline plans. I also understand that the PBGC's estimates of their $23-billion fiscal deficit assume a number of airline industry plan takeovers in its "probables." Obviously, whatever we can do to stop these plans from being taken over by the PBGC will be in the best interests of both the airline employees and the taxpayers. I am hoping that we can examine creative ways of allowing the airlines to fund the promises that they have made to our constituents without increasing the potential liability of the PBGC and the taxpayers. What impact do you think the administration's proposed funding rules would have on the airline industry? Are you willing to work with this committee to examine ways that the situation with the airline industry can be addressed while meeting the dual goals of supporting the industry and its employees and protecting the taxpayers from potential increased liability?

Answer: The administration proposal was designed to address problems in the single-employer defined benefit system as a whole. We did not model the effects on individual firms or industries. With respect to your concern about the effects of the proposal on financially weak firms, it is important to bear in mind that the proposal includes a 3-year transition period to the yield curve and extends amortization periods for many under-funded plan from as little as 4 years (under the deficit reduction contribution) to 7 years.

We are willing to discuss any issues of interest to the committee. Current law and the administration proposal will allow for the granting of temporary funding relief to pension sponsors in temporary financial difficulty through the waiver process. In general, we are opposed to specialized treatment for any one industry. The pension insurance system is not designed to provide or capable of providing aid to companies competing in restructuring industries. It is designed to insure benefits for participants in plans that fail.

RESPONSES TO QUESTIONS FROM SENATOR HATCH

Question: Mr. Warshawsky, I certainly share your concern about the need for reforming the funding rules for defined benefit plans. Do you believe that the administration's proposal, if enacted in its entirety, would stave off the crisis facing the PBGC?

Answer: Yes, we believe so. In our view, the existing funding rules for single-employer defined benefit pension plans and the current premium structure financing the PBGC are the primary causes of the current crisis. We believe that if our proposal were enacted, plan funding would improve significantly and PBGC would be restored to financial health.

The existing funding rules have a number of fundamental flaws that the proposal addresses directly. Current funding rules attempt to insulate pension plans from financial market realities through smoothing mechanisms built into the measurement of plan assets and liabilities. These rules were created in an attempt to reduce the year-to-year variation of sponsor pension contributions. Such smoothing has not only failed to accomplish this objective, but has contributed to the widespread plan under-funding and mismeasurement we see today.

The administration takes the view that pension rules should provide plan sponsors with the tools to manage volatility, including amortization over 7 years and extra opportunity to pre-fund benefits in good times. The rules should encourage use

of these tools as well as available financial market tools to reduce contribution volatility rather than artificially smoothing asset and liability values and distorting current economic reality. In order to encourage such behavior, assets and liabilities will be measured on a current and accurate basis under the administration's proposal. Liabilities will be measured using a yield curve that matches appropriate market interest rates to the time structure of the pension plan's projected cash flows.

The administration proposal also raises the ceiling on deductible contributions. This will allow those plan sponsors to build funding surpluses in order to reduce contribution volatility.

Current funding rules allow plans to stop making contributions before all accrued benefits are funded, and credit balances allow under-funded plans to take funding holidays. The administration proposal will require all plans to fund to a minimum target that is at least equal to the value of accrued benefits. The proposal also eliminates credit balances.

Current rules also set the same funding target for all plans regardless of differences in the risk of termination. The administration's proposal would recognize the additional termination risks posed by plans sponsored by financially weak firms. Such plans will be required to fund to a target commensurate to these risks.

Lastly, the current premium system provides little incentive for plans to remain well-funded and generates insufficient revenue to cover losses in the pension insurance program. The system has relied primarily on flat premiums, per capita charges that do not vary from plan to plan, to produce most of its revenues. The premium rate of $19 per participant has not been raised since 1991 even though the PBGC's guarantee limits are annually indexed to wage growth. The administration proposal would raise premiums immediately to $30 to account for wage growth since 1991. Flat-rate premiums would be indexed in the future using the same index used to update the guarantee limits.

Although there is a premium charge for plan under-funding in the current structure, many under-funded plans qualify for exemptions each year and do not pay that premium. As long as under-funded plans are at the "full funding limit," which generally means 90 percent of current liability, they do not have to pay the variable-rate premium. That is why some of the companies that saddled the insurance fund with its largest claims paid no variable-rate premium for years prior to termination. In fact, less than 20 percent of participants are in plans that pay a variable-rate premium.

The administration proposal would charge risk-based premiums to every plan with unfunded target liabilities without exception. We believe that this will provide a powerful incentive for plan sponsors to fund at or above their plan targets. Linking premiums to funding targets also means that the proposal will introduce the risk of plan termination into the insurance system's premium structure for the first time. Revenue from both the risk-based and flat-rate premiums will be used to retire PBGC's current deficit over an extended period of time and to pay expected future claims.

Question: Looking at a the bigger picture, I see the private sector moving away from defined benefit plans and toward defined contribution plans. I have two questions for you. First, do you see the changes proposed by the administration as having the power to revitalize the DB sector so that new plans would be adopted, or are we facing a dying breed no matter what we do to change the rules?

Answer: The administration believes that defined benefit pension plans should remain an option for those firms that wish to provide guaranteed retirement benefits to their employees. In our view, the current pension funding system will not be sustainable in the long run. The administration's proposal would revitalize the system by placing both the pension insurance program and individual pension plans on sound financial footing.

Under the current system, there are significant disincentives for new employers to create defined benefit plans, such as the substantial deficit of the sponsor-financed insurance fund. Prospective defined benefit sponsors are also aware that the current complex system of funding rules allows some sponsors to transfer the risks of their funding and investment decisions to that same insurance system. We believe that these considerations—risk transfers and administrative complexities—also make defined benefit plans unattractive to prospective plan sponsors.

The administration's proposal will correct these flaws. Tightening funding rules and returning the pension insurance program to financial health will make defined benefit plans more attractive to employers who are now outside the system.

The administration also believes that Congress should act promptly to clarify the legal status of cash balance and other hybrid pension plans. The only new defined benefit plans created in recent years have been alternative benefit structures, such as cash balance or pension equity plans that are designed to meet the needs of a

younger, more mobile workforce. Unfortunately, as a result of a single Federal court decision, the legal status of these types of plans is in question.*

Question: Second, many experts believe that hybrid pension plans may be the key to a vibrant future for defined benefit plans, yet hybrids seem to be stymied by legal problems. Do you think that addressing hybrid plans is as urgent as dealing with DB plans this year?

Answer: Addressing the current crisis in funding of single-employer defined benefit plans and removing uncertainty about the basic legality of cash balance plans are both critical to preserving the vitality of the defined benefit system, which provides retirement income security for millions of American workers and their families.

We have a legislative proposal in our budget relating to cash balance and other hybrid plans which would not only protect the defined benefit system by clarifying the status of cash balance plans, but also ensure fairness for older workers in cash balance conversions and remove the effective ceiling on interest credits in cash balance plans.

Responses to Questions From Senator Rockefeller

Question: I am very concerned with some of the administration's suggestions for limiting benefit increases and accruals. It seems to me that these changes would punish workers in cases where company management fails to invest enough money in the pension plan.

The administration has claimed that these benefit restrictions would prompt workers to put pressure on employers to better fund pension plans. However, it is not clear to me how workers could effectively stop employers from under-funding plans.

I would like to hear how you expect workers to protect themselves, and please specifically address how they could do so *between* contract negotiations as their benefits are being cut.

I would also like to know what would prevent an employer from purposely under-funding the pension plan in order to deprive workers of hard-won pension benefit increases?

Answer: The administration believes that we must ensure that companies make only benefit promises they can afford, and keep the promises already made by appropriately funding their pension plans. When companies are unable to keep their pension promises, the losses are shifted to the pension insurance system and to workers. It is these empty promises that harm workers by putting their retirement security at risk. The new stronger minimum funding rules combined with the proposed limitations will prevent companies from making hollow promises.

The stronger minimum funding rules will prevent employers from purposely under-funding their pension plans. Companies will be required to fund their plans up to a meaningful funding target. Companies that fall below the minimum funding target will be required to fund up to the target within a reasonable period of time. A plan sponsor that is operating outside of bankruptcy cannot ignore its funding obligations without serious consequences. There are significant enforcement measures available to the IRS and the PBGC to prevent firms from ignoring funding obligations.

The proposed benefit limitations will apply only when a plan's funded status falls below acceptable levels. The limit on benefit increases for certain under-funded plans will prevent companies from promising additional benefits unless promises already made to workers are adequately funded. The limit on accruals will apply only for plans with severe funding shortfalls or sponsors in bankruptcy with under-funded plans. The limitations will not affect benefits already earned. Rather than deprive workers of hard-won pension benefit increases, we believe that these proposals create a strong incentive for employers to adequately fund their plans—making it more likely that workers' retirement expectations will be met. Our proposal takes into account existing collective bargaining agreements by not applying these benefit limitations until the earlier of the end of the contract term or 2009.

Plans that become subject to any of the benefit limitations will be required to notify affected workers, making them aware that deteriorating funding is threatening their benefits. Workers need this information so that they can have realistic expectations about their company's ability to fund pension promises. We also believe that

Cooper v. *IBM Personal Pension Plan,* 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle* v. *ARINC, Inc.,* 222 F.R.D. 88 (D. Md. 2004); *Eaton* v. *Onan Corp.,* 117 F. Supp. 2d 812 (S.D. Ind. 2000).

in some instances, companies will improve the funding of their plans in order to avoid notifying workers and thereby creating worker dissatisfaction.

Question: I am very concerned that the administration has made no proposal to address the pension crisis in the airline industry. A considerable amount of the deficit facing the PBGC is expected to derive from failing airline pension plans. Yet the administration has proposed no remedies specific to that industry that would help airlines maintain their plans.

Some airlines have asked Congress to consider relief that would allow them to essentially restructure their pension plans. By giving the companies a longer time period to pay off debt and perhaps limiting the PBGC's exposure to increases in pension liabilities, airlines may be able to save their pension plans.

What industry-specific relief is the administration willing to consider to protect the pension benefits of airline employees and help the companies maintain promises they made to their workers?

Answer: We understand the financial difficulties the airlines are facing. Congress and the administration have provided assistance to the airlines in the form of grants, loan guarantees, and short-term funding relief when such assistance was determined to be appropriate.

The administration's pension reform proposal would strengthen the funding rules to improve the health of the entire defined benefit pension system. This is particularly important for those under-funded plans that pose the greatest risk of terminating. Neither the defined benefit system nor the pension insurance system is designed to provide or capable of providing targeted relief to specific industries. It is designed to insure benefits for participants in plans that fail.

Relaxing the funding rules for a specific industry would set a dangerous precedent for the pension insurance program. We do not believe that the interests of participants, other premium payers, or the taxpayer are best served by allowing companies to effectively borrow from their employees and the insurance fund to meet their financial obligations.

I would also emphasize that the majority of losses incurred by the PBGC to date have been in industries other than airlines and that the majority of the insurance fund exposure to "reasonably possible" claims is in other industry sectors. So, the financial pressures on the pension insurance program are not unique to the airline industry.

Current law allows plan sponsors to obtain funding waivers if they are experiencing temporary substantial business hardship. The IRS can, in consultation with the PBGC, and often does, impose conditions on obtaining a waiver that protect the interests of participants and the pension insurance program.

Question: I appreciate the difficulty we are facing in trying to shore up the defined benefit pension plan system. On the one hand, we want to better protect workers by making sure that employers are adequately funding their pension promises. On the other hand, we want to encourage employers to continue to provide defined benefit pensions that protect workers and retirees from the risks associated with the stock market.

I am very concerned that the administration's proposal focuses just on addressing the deficit faced by the PBGC. Many aspects of this proposal would increase funding to the PBGC, but actually make it much harder for employers to maintain these plans.

For example, the yield curve proposed by the administration would be much more volatile and difficult for employers to predict and plan for. The yield curve also substantially increases the liability calculations for industries that have older workers. Even healthy plans would see substantial premium increases under the administration's reforms.

I am concerned that these are shortsighted fixes to the PBGC's funding problems. As defined benefit plans become more and more expensive for employers, many companies will simply shift away from offering such pensions. As healthy plans voluntarily terminate, the funding problems in the system increase, creating a vicious cycle.

How does the administration propose to encourage companies to continue to offer defined benefit plans?

Answer: We would respectfully disagree that the administration's proposal focuses just on improving the pension insurance program deficit or that it would or should cause employers to abandon their pension plans. We believe the proposal appropriately balances competing considerations. The objective is to ensure that plan sponsors honor the promises they have made, and the proposal requires companies to make up their funding gap over a reasonable period of time. At the same time, the administration's proposal provides additional flexibility for plan sponsors and

provides numerous incentives for them to maintain and prudently fund the plans they sponsor.

For example, companies will be able to make much larger tax-deductible contributions to their plans during good economic times than under current law. Companies that contribute more than the minimum requirement would effectively shorten the amortization period. They would be able to reduce the amount of risk-based premium that would have to be paid. And companies would likely benefit from improved credit ratings if they reduced their unfunded pension liability, thus lowering their cost of capital.

We also do not agree that the administration's proposal would lead to greater volatility and make it more difficult for companies to predict their funding requirements. The risk and volatility in the pension plan is a function of the business decisions made by the company. Current law simply masks that volatility and allows companies to shift the risks to third parties. It is because of current-law features like smoothing and credit balances that plans sometimes are so under-funded when they terminate. Hiding the problem doesn't make it go away. There are numerous ways under the administration's proposal in which companies can minimize risk and volatility and make funding more predictable.

The administration also believes that Congress should act promptly to clarify the legal status of cash balance and other hybrid pension plans. The only new defined benefit plans created in recent years have been alternative benefit structures, such as cash balance or pension equity plans that are designed to meet the needs of a younger, more mobile workforce. Unfortunately, as a result of a single Federal court decision, the legal status of these types of plans is in question.*

RESPONSES TO QUESTIONS FROM SENATOR SMITH

PAYOUT OPTIONS

Question: So many of the demographic figures I have seen lately speak to the fact that more and more of the responsibility for accumulating retirement savings is shifting to the individual. Half of American workers get help from their employers in the form of employer-provided savings, and half of our workers must do it on their own. Of course we're here discussing some of the ways to achieve further security for those who do have such access to traditional pensions and what can be done to make them more secure.

I have actually introduced legislation that would give the same guaranteed payout streams as traditional pensions to those who do not have access to such employer-provided plans. What the legislation provides is an incentive to consider the "delayed gratification" of an annuitized payout you can't outlive when compared against the "instant gratification" of receiving a simple lump sum.

The reason why I raise this issue is that even the defined benefit pension plans we are discussing today are trending increasingly toward paying lump sums at retirement; in particular, cash balance plans. For those of us concerned that retirees need to consider taking a guaranteed payout stream rather than just a lump sum, what can you tell me about your plans that will create some payout options for retirees?

Answer: The administration's funding proposal will strengthen and preserve the defined benefit system. Preserving the system will enable more workers to have the option of taking their pension distributions in the form of annuities. The administration's proposal also eliminates an inappropriate incentive for participants to take lump-sum distributions.

Under current law, the use of an inappropriately low discount rate for determining the value of lump sums creates an incentive for participants to choose lump sums. Under our proposal, the yield curve would be used to calculate minimum lump sums, which will eliminate this distortion that can bias a participant's payout decision toward lump sums. 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.

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* *Cooper* v. *IBM Personal Pension Plan,* 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle* v. *ARINC, Inc.,* 222 F.R.D. 88 (D. Md. 2004); *Eaton* v. *Onan Corp.,* 117 F. Supp. 2d 812 (S.D. Ind. 2000).

MULTIEMPLOYER PLANS

Question: It is my understanding that the administration is not planning on taking any action on multiemployer plans in the near future. However, there is a crisis brewing among the multiemployer plans as well. Some very large plans are close to having to go into "reorganization," and many retirees in my State of Oregon will be impacted. Does the administration plan on reporting to us on the risk that the multiemployer system would have to assume if some of these multiemployer plans become insolvent?

Answer: The administration recognizes that changes in the multiemployer funding rules are necessary. However, we focused on single-employer plans first because the problems facing single-employer plans are more immediate and acute. Also, due to the unique nature of multiemployer plans, not all elements of the single-employer proposal could be immediately applied to multiemployer plans. We believe it is vitally important that Congress enact legislation to protect the retirement security of workers in these single-employer pension plans. At the same time, however, we must remember that there are millions of Americans who are covered by multiemployer pension plans, and that their retirement security is equally important. We should work together in a bipartisan fashion to ensure that multiemployer plans are strengthened.

The multiemployer insurance program covers about 9.8 million workers and retirees in about 1,600 plans. The program has only one source of funds, an annual premium payment of $2.60 per participant that generates about $24 million of income per year.

The PBGC insurance comes into play when a multiemployer plan becomes insolvent—that is, when the plan does not have enough assets to pay benefits that fall under the statutory limit, which was originally set at less than $6,600 per year for a retiree with 30 years of service. In 2001, Congress amended the law to double the limit—to $12,870 per year—but did not increase the premium. Between 1980 and 2000, relatively few multiemployer plans failed; the agency paid out $167 million to some 33 plans.

Recently, however, more plans have failed. In its 2004 Annual Report, PBGC estimates that financial assistance payments to multiemployer plans denoted as "probables" will reach $30 million in 2005, $90 million in 2006, and $100 million per year for at least a decade thereafter. In addition, it is "reasonably possible" that other multiemployer plans will require future financial assistance in the amount of $108 million in present-value terms.

The multiemployer program ran surpluses for over 20 years until it recorded its first deficit of $261 million in FY 2003. The multiemployer program reported a deficit of $236 million in FY 2004. This is in contrast to the $23.3-billion deficit in the single-employer program.

In the 2004 Annual Report, PBGC estimated that, as of September 30, 2004, the total under-funding in insured multiemployer plans is more than $150 billion, compared to a 2003 estimate of more than $100 billion.

The Government Accountability Office recently completed a study that concluded that multiemployer plans face long-term challenges, and we agree with this assessment. Because multiemployer plans are creatures of collective bargaining, the dwindling percentage of union coverage in private-sector employment has halted growth. In addition, a substantial number of plans are concentrated in industries such as trucking and retail foods, where employers and unions will encounter increased cost competition from new competitors.

The PBGC is required by law to review the multiemployer plan insurance program every 5 years to assess, in a report to Congress, whether changes in the current guaranteed benefit can be supported by the existing premium structure. The PBGC expects to complete work on the next 5-year report in late 2005.

PBGC LIABILITY

Question: In measuring its liability, the PBGC has historically used an interest rate that is well below market rates. What would the PBGC's deficit be using the corporate bond interest rate that Congress enacted last year? And, what would the PBGC deficit be using the administration's yield curve methodology?

The administration's proposals would require some employers to make much larger pension contributions starting right away. How much modeling has the administration done to determine how many companies would not be able to meet those sudden increases in cash flow demand? How certain are you that we will not see more bankruptcies as a direct result of this proposal and that you will only be turning some of those "probables" into "definite problems" for the PBGC?

Answer: Actually, the PBGC does use market prices for valuing its liabilities both on its financial statements and for our claims in bankruptcy. The PBGC conducts surveys of the prices charged by private-sector insurance companies to write group annuity contracts and derives an interest factor from those prices that, with PBGC's mortality table, will match the prices. The rationale for this approach is that it maintains a "level playing field" between plans that terminate with PBGC and plans that terminate in the private sector. Put another way, if a plan sponsor determined to terminate its plan (which would have to be fully funded) and annuitize the benefits to its employees, a private-sector annuity provider would value those liabilities the same way that PBGC does.

Using an interest factor based on prices for annuities charged by private-sector insurance companies, the PBGC's single-employer deficit was $23.3 billion. If PBGC had valued liabilities using 100 percent of the spot corporate bond rate that is currently used for determining PBGC premiums, the deficit would have been about $18 billion. (Pursuant to legislation enacted by Congress last year, the corporate bond rate is used differently for different purposes: (1) a 4-year weighted average is used to determine plan funding, and (2) a spot rate is used to determine PBGC premiums.) If, instead, the PBGC had valued liabilities using the administration's yield curve methodology, the deficit would have been about $19 billion. Both estimates assume that PBGC would continue to include in liability estimates the present value of its own future expenses as it does under current procedures. It is also important to note that while the single-employer deficit would be lower using these approaches, there still would have been a dramatic swing in the corporation's financial position from a surplus to a very large deficit over the past 3 years.

We have modeled the proposal in the aggregate for the entire defined benefit system. The data indicate that the funded status of both healthy ongoing and at-risk plans improves over time under the administration's proposal, which is the core objective of reform. We should not lose sight of the fact that the current funding rules don't work and have allowed the huge funding gap to develop and grow. Absent the kind of fundamental changes in the administration's proposal, there is a significant risk that the level of under-funding in terminated plans will get much larger. We do not have the information needed to evaluate the financial impact of the proposal on particular plan sponsors. We believe that the funding rules should apply to all plan sponsors, and it would be inappropriate to create special rules for a particular industry or company.

Various underlying business factors apart from pension funding lead to corporate bankruptcies. That will continue to be the case in the future. If we make no changes in the funding rules or further relax them, plans of bankrupt firms will be more under-funded, participants will lose more benefits, and the taxpayer will be put at greater risk.

It is in everyone's best interest to keep well-funded plans in the defined benefit system. At the same time, as we have seen, plan under-funding is destabilizing to the system. These concerns are fairly and effectively addressed by the administration's proposal, which would require funding of benefit promises over a reasonable period of time.

RESPONSES TO QUESTIONS FROM SENATOR SNOWE

Question: With respect to the administration's proposal to require plan sponsors to use a yield curve for purposes of calculating their funding obligations, how much modeling has it done to determine how many companies would not be able to meet those sudden increases in cash flow demand?

Answer: The administration proposal was designed to address problems in the single-employer defined benefit system as a whole. We did not model the effects on individual firms or industries.

The modeling indicates that the funded status of both healthy ongoing and at-risk plans improves over time under the administration's proposal, which is the core objective of reform. Our current modeling does not include the information needed to evaluate the financial impact of the proposal on particular plan sponsors.

With respect to your concern about sudden increases in cash flow demand, it is important to bear in mind that the proposal includes a 3-year transition period to the yield curve and extends amortization periods for many under-funded plans from as little as 4 years (under the deficit reduction contribution) to 7 years.

Question: Assuming again the implementation of a yield curve, is the administration concerned that this change might actually lead to certain employers that have currently a defined benefit plan shutting it down and dumping the responsibility onto the PBGC?

Answer: The yield curve provision is designed to measure liabilities by matching current market interest rates for obligations of the appropriate maturity to the time structure of a pension plan's projected cash flows. We believe that this is the most accurate way to measure plan liabilities. The administration recommends use of the yield curve so that pension sponsors recognize the real costs of operating defined benefit pension plans.

Only when such costs are recognized can sponsoring firms make responsible business decisions about how to design their retirement plans. Intentionally understating plan costs by mismeasuring liabilities creates future financial problems for plan sponsors, workers, and retirees.

Question: My next question on the yield curve goes to the efficiency with which plan sponsors will implement this sudden change. Specifically, how do you respond to critics who contend a yield curve approach will be overly complex and create cost-prohibitive barriers for plan sponsors?

Answer: As I explain in my written testimony, implementing the yield curve is not complex. A simple numeric example is included in that written testimony demonstrating how the yield curve can be used in computing pension liabilities.

We have seen no evidence that implementation of the yield curve will pose a difficult technical challenge for actuaries or that it will cause significant increases in pension plan administrative expenses.

Question: Finally, I am not sure that a yield curve approach will do an adequate job of "smoothing over" a company's ultimate plan funding. Specifically, one of the administration's proposals is to permit companies to contribute extra money into their plan above their required contribution without being penalized and while still being entitled to an income-tax deduction. The logic here is that it will allow companies to over-fund their plans during good economic times so that they can better weather the storm during less prosperous times. However, that logic seems to break down if we adopt a yield curve. Specifically, the interest rates under a yield curve approach are not averaged over a specified period of time. Without a weighted average, pension liabilities will be much more volatile from year to year, making it more challenging for companies to develop a reliable long-term financial and/or strategic plan for their company. What is the administration's response to this claim?

Answer: The administration takes the view that pension rules should provide plan sponsors with the tools to manage volatility, including amortization over 7 years and extra opportunity to pre-fund benefits in good times. The rules should encourage use of these tools as well as available financial market tools to reduce contribution volatility rather than artificially smoothing asset and liability values and distorting current economic reality. In order to encourage such behavior, assets and liabilities will be measured on a current and accurate basis under the administration's proposal. Liabilities will be measured using a yield curve that matches appropriate market interest rates to the time structure of the pension plan's projected cash flows.

The administration proposal also raises the ceiling on deductible contributions. This will allow those plan sponsors to build funding surpluses in order to reduce contribution volatility.

Prepared Statement of Larry Zimpleman

Mr. Chairman and members of the committee, thank you for the opportunity to appear before this committee. My name is Larry Zimpleman, and I am President of Retirement and Investor Services at The Principal Financial Group. I am a member of the Society of Actuaries and the American Academy of Actuaries.

Today, I am here on behalf of the Business Roundtable, an association of CEOs from the largest employers in the world. Principal Financial's Chief Executive Officer, Barry Griswell, is Vice Chairman of the Business Roundtable's Health and Retirement Taskforce. The American Benefits Council, the American Council of Life Insurers, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the U.S. Chamber of Commerce also join in the themes expressed in this testimony and some of these groups will be submitting their own supplemental testimony.

Mr. Chairman, we commend you, Senator Baucus, and the other members of the Finance Committee for tackling the critical issue of defined benefit pension reform. Your past leadership on these and other retirement issues has led to many of the recent improvements that have strengthened our Nation's retirement system, and we urge you to continue to be active in retirement issues. We want to work with Congress and the administration to build a more robust defined benefit system.

The best way to protect pensions for future retirees and working Americans is for Congress to enact permanent rules that lead to a fair and stable system. The unexpected termination of the 30-year Treasury bond in 2001, and the subsequent temporary fixes to the interest rate used for pension calculations have made it impossible for employers to project future pension contributions. This uncertainty has significantly compromised employers' ability to make new capital investments, hire new employees, make R&D investments or take other actions that ensure the future of U.S. business. The current fix expires at the end of this year, and it is imperative that Congress enact a permanent interest rate as soon as possible. In addition, uncertainty regarding the status of cash balance and other hybrid plans is stifling innovation and flexibility in pension plan design. Affirming the legality of these plans, which cover more than 7 million Americans, is a necessary step to a vibrant defined benefit system. Congress should act quickly to provide the certainty that is needed in both of these areas.

We agree that other targeted reforms are needed as well. Pension plans must be appropriately funded. Pension promises that are made are promises that must be kept because the retirement security of millions of Americans is dependent on those promises. Employers should not be able to make pension promises they should reasonably know they cannot keep. These practices pose a threat to participants and to the Pension Benefit Guaranty Corporation (the "PBGC"). But strengthening the PBGC should not happen at the expense of the defined benefit plan system or the economy. This testimony sets out some of the reforms that we believe should be made and details our concerns about other reform proposals.

First and foremost, any reform proposal should be measured by the benefits or consequences for the U.S. economy. It is in no one's interest for pension reform to disrupt our economy or the capital markets, since a strong economy benefits workers, retirees, plans, employers and the PBGC. Ill-conceived changes in pension rules could drive employers out of the defined benefit system, eroding the retirement security of American workers. In the worst case, excessive changes could tip some employers into bankruptcy—costing those workers not only retirement savings but potentially their jobs. We owe it to those Americans and their families to ensure that changes, no matter how well-intentioned, are not counter-productive.

PRINCIPLES FOR REFORM

We believe that reform in the defined benefit system should be based on the following principles:

- *Ensure the continued success of the defined benefit pension system.* The pension system benefits millions of Americans, with over 34 million participants currently relying on single-employer defined benefit pension plans as a critical element of their retirement security. Reforms, no matter how well-intentioned, should not drive employers out of the system.
- *Avoid disrupting or undermining the economy.* Nearly $2 trillion is held by private-sector pension plans, and the pension system accounts for 6 percent of all U.S. equity investments. It is essential that any reforms avoid abrupt and unnecessary disruption to the U.S. economy.
- *Protect employer flexibility.* To compete effectively and attract and keep skilled workers, employers must be able to tailor pension plans to the unique needs of their workers and the competitive environment in which they function. The flexibility to utilize varied pension plan designs, including cash balance and other hybrid plans, is imperative if we are to maintain a vital defined benefit system.
- *Provide predictability in future pension costs.* Pension policy must provide employers with the certainty that will allow them to make new capital investments, to hire new employees, and to make R&D investments.
- *Preserve rules that minimize funding volatility.* It is essential that any reforms reflect the long-term nature of pension promises and smooth liability and asset valuations. Volatility in these calculations makes it impossible for employers to plan and make prudent business decisions, slowing the economy. Volatile pension funding rules can also exaggerate economic cycles, leading to deeper recessions and greater job loss during down times.
- *Advance rules that promote pension plan funding.* The pension system should encourage employers to make contributions to their plans as early as possible and ensure there is no disincentive to fund plans in advance of future liabilities. We strongly support the proposals like those previously approved by this committee to revise the tax deduction rules that prevent employers from contributing to defined benefit plans during good economic times.

- *Provide timely and appropriate information to participants.* Participants should have the information they need to evaluate their retirement security. Existing funding disclosure requirements should be enhanced to provide timely and useful information about retirement plans, while at the same time avoiding the creation of costly, confusing or misleading new requirements.
- *Minimize the moral hazard in the pension system.* Plan sponsors that make pension promises they cannot keep only to "shift" their liabilities to the PBGC pose a hazard to other sponsors participating in the system. Careful consideration should be given to reforms that prevent benefit increases that are not likely to be funded within a reasonable period of time.

KEY ISSUES

A few weeks ago, Secretary of Labor Chao and PBGC Director Belt released a broad package of proposals that would completely change the funding rules applicable to single-employer defined benefit plans. There are a number of themes in the administration's proposals that are consistent with the reform principles we recommend. For example, the administration's focus on better disclosure to plan participants is a goal we share. Similarly, proposals to change the tax rules to allow employers to make larger contributions during good economic times are long overdue.

On the other hand, some of the reform proposals represent an unnecessary wholesale departure from the existing rules. Starting from scratch exacerbates the risks. Most of the reform proposals were presented for the first time in the FY 2006 Budget Proposal. Without understanding the impact of the proposals as a whole, the damage to the system and our economy could be substantial. The following provides a more detailed analysis of certain key issues that are raised by the administration's proposals.

Making the long-term corporate bond rate permanent

In our view, the need to permanently replace the obsolete 30-year Treasury bond rate used for pension calculations is the most pressing issue facing employers that sponsor, and individuals who rely on, defined benefit pension plans. Without a permanent interest rate fix, employers cannot project their pension costs beyond 2005 and make informed business decisions. Today, a long-term corporate bond rate averaged over 4 years is used on an interim basis to determine "current liability" for the funding and deduction rules and to determine unfunded vested benefits for purposes of PBGC variable-rate premiums. However, the measurement rate defaults to the rate on the now defunct 30-year Treasury bond beginning in 2006 if no further action is taken. It is widely agreed that the 30-year Treasury bond is no longer a realistic measure of future liabilities and would inappropriately inflate pension contributions and PBGC variable-rate premiums, especially during times of historically low interest rates similar to the interest rate conditions we are experiencing today. A return to an inappropriate and inaccurate measure of pension liabilities and the resulting inflated contributions caused by the defunct 30-year Treasury bond rate would be devastating for the ongoing vitality of the defined benefit system and would be enormously disruptive for employers and the strength of the economy.

We believe the best way to protect the pension system for future retirees is to make permanent the long-term corporate bond rate that Congress adopted last year. As Congress has recognized, the long-term corporate bond rate provides a realistic picture of future pension liabilities and is the best measure to ensure the adequacy of pension funds for future retirees. The long-term corporate bond rate reflects a very conservative estimate of the rate of return a plan can be expected to earn and thus is an economically sound and realistic discount rate. Plans generally invest in a diversified mix of equities and bonds. For long-term obligations, plans generally invest in equities because equities have historically earned a greater rate of return than bonds. For mid-term liabilities, plans generally invest in a mix of equities and bonds and, for short-term liabilities, plans invest more in short-duration bonds. The net effect is that plan's have historically earned higher rates of return than even the rate of return on long-term corporate bonds. For this reason, the long-term corporate bond rate is a very conservative measure of liability.

We also believe that the interest rate used for determining the amount of lump-sum distributions should be conformed to the interest rate used for determining liabilities. Under current law, lump sums cannot be less than the amount determined using the defunct 30-year Treasury bond rate. This artificially inflates lump sums, which has contributed to funding pressures, and we support using the long-term corporate bond rate to determine lump-sum payments.

It is important that the permanent interest rate that is chosen for funding and lump-sum purposes be a fair and stable rate. We appreciate that the administration

has stepped forward with a proposal that recognizes the need for permanent replacement of the obsolete 30-year Treasury bond rate. However, we remain deeply concerned that the yield curve aspect of the proposal could produce an effective interest rate that is too low and therefore will overstate liability. Relative to the weighted long-term corporate bond rate in effect this year, the administration's proposal could increase pension liabilities for a typical mature plan by 10 percent or more. In some cases, the immediate liability increase could be even greater. For large plans, this could cost billions of dollars. These dollars are far in excess of what is needed to provide a high degree of certainty that plans have enough to pay benefits. Moreover, the shape of the yield curve itself, as it steepens and flattens over time, could have a dramatic impact on mature plans.

The consequences of excessive contribution obligations are painfully clear. This is precisely what happened when inflated pension contributions were mandated by the obsolete 30-year Treasury bond rate. Employers that confront inflated contribution obligations will have little choice but to stop the financial bleeding by freezing or terminating their plans. Both terminations and freezes have truly unfortunate consequences for workers—current employees typically earn no additional pension accruals and new hires will not have a defined benefit plan whatsoever. Government data reveals that defined benefit plan terminations accelerated prior to the temporary long-term corporate bond rate fix in the Pension Funding Equity Act of 2004, with a 19-percent drop in the number of plans insured by the PBGC from 1999 to 2002. Just as troublesome, the statistics above do not reflect plans that have been frozen. While the government does not track plan freezes, reports make clear that these freezes were on the upswing.

Inflated pension contributions also divert precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had anticipated, employers will not hire new workers, invest in job training, build new plants, and pursue new research and development. These are precisely the steps that would help lower our Nation's unemployment rate, spur individual and corporate spending, and generate robust economic growth.

There are also questions about whether the interest rate changes proposed by the administration can stand the test of time. Current law requires employers to make contributions equal to the greater of contributions required under the deficit reduction contribution rules (the "DRC rules") or the ERISA funding rules. The proposal would eliminate the ERISA funding rules and replace the current system with a single-tiered system modeled on the DRC rules. The ERISA funding rules play an important role because they reflect that for liabilities that span many years, providing a specific value on a specific day has little meaning in today's volatile market environment. Because the ERISA rules use a long-term interest rate to value liabilities, the ERISA rules remain an appropriate measure of liability for many defined benefit plans. The proposal to eliminate the ERISA funding rules could lead to serious under-funding in a high interest rate environment.

Moreover, even with the proposed increase in permissible deductible contributions, employers would be prohibited from adequately funding their plans in high interest rate periods—contributions that would be permitted under today's rules. As we have modeled the yield curve proposal, there are significant periods over the last few decades in which contributions would not have been possible. For example, during the early 1980s when many companies made significant contributions to their plans, the administration's interest-rate proposal would have barred many of these companies from contributing.

Finally, we would note that the Treasury's yield curve methodology would also add complexity to an already overburdened system. The proposal would generate a series of interest rates for each participant. This level of complexity may be manageable by large employers, particularly sophisticated financial employers. However, it would impose a substantial burden on small and mid-sized employers, and even large employers that do not utilize a yield curve in their day-to-day operations. We also note that there are a myriad of questions about the construction and composition of the yield curve. The proposal is intended to reflect the market. However, the markets for corporate bonds of many durations are so thin that the interest rates used would need to be created internally by the Treasury Department. More generally, we are concerned that the interest rate constructed by the Treasury Department would be opaque and that it would be virtually impossible for employers to model it internally as part of corporate planning. This type of an interest rate would also be particularly difficult for Congress to oversee.

Preserving rules that make pension funding predictable

Predictable funding rules are important because they allow employers to make long-term financial plans. Future pension costs can represent significant invest-

ments—more than $1 billion per year for some employers. Financial decisions of this magnitude require planning and substantial lead time. This can only occur with predictable funding rules.

We are concerned that the administration's proposal will dramatically increase the already volatile and unpredictable funding rules by moving to a spot valuation of liabilities based on interest rates for the preceding 90 business days. In contrast, under current law, pension liability is valued using a weighted average of interest rates for the preceding 4 years. The use of a spot rate to value liability is one of a number of features of the administration's proposal that would move plans towards mark-to-market measurement, including, for example, the proposed elimination of actuarial valuations of assets and proposed imposition of PBGC variable-rate premium obligations any time a plan is less than 100-percent funded on a spot basis.

As a threshold matter, it is critical to recognize that spot valuations do not mean tougher funding standards. Total funding remains the same; the spot or smoothed rate only affects when contributions are due and the degree of volatility associated with those contributions. As interest rates rise, a spot rate will result in smaller contributions and vice versa. Over the long-term, contributions are the same. Further, spot valuations are neither accurate nor meaningful for pension liabilities that span many years. A spot interest rate for 90 days is not a particularly accurate measure of liabilities that in many cases span more than 40 years.

As we have begun to model the administration's proposals based on information provided to date, declines in funded status of 10 percent or more from year to year would not appear to be out of the ordinary. For most employers, such a swing would mean a dramatic increase in funding, regardless of any amortization of the shortfall. The pension funding rules are already unpredictable and volatile, and many sponsors have opted out of the system because of this lack of predictability. Surveys suggest that employers view this as the top impediment to maintaining a defined benefit plan. For this reason, we are concerned that the spot rate proposal could have disastrous consequences for the ongoing vitality of the system.

We are also concerned that the proposed use of a spot rate could have very negative implications for the U.S. economy. Spot valuations require larger contributions during economic downturns and smaller contributions during economic upturns. Larger contributions reduce capital spending. This exaggerates downturns and upturns. The result is that the economy overheats during upturns and has deeper recessions during downturns. In economic terms, spot valuations have a "procyclical" effect on the economy. Research done at the request of the Business Roundtable indicates that the use of the spot rate relative to current law would have significantly exaggerated the most recent economic downturn.* For example, econometric modeling** suggests that a spot rate would have cost the economy more than 300,000 jobs during 2003. This would not have meant improved funding over the long haul, only exaggerated economic cycles and job losses.

Some have suggested that defined benefit plans can manage the lack of predictability in a spot rate proposal by investing in bonds and financial derivatives that hedge against interest rate movements. Hedging can be very expensive, and plans should not be effectively forced to incur this cost. For many defined benefit plans, their investment policy committee does not allow the use of any form of derivatives. Even for plans that want to hedge, it is far from clear that there ever could be enough bonds or other instruments to permit plans to hedge their liability against interest rate movements. For example, hedging in bonds would require using the particular class of bonds that compromise the relevant interest rate benchmark. The administration's interest rate is comprised solely of AA bonds, and it is doubtful that there would ever be a deep enough market in this particular class for many plans to effectively hedge. Further, there are a limited number of derivatives issuers, and a significant movement towards derivatives would concentrate risk within a handful of financial institutions. The potential consequences of concen-

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*Results of a study prepared by Robert F. Wescott, PhD. Dr. Wescott is an economist who works on macroeconomic, financial, and pension savings issues. Dr. Wescott served as Chief Economist at the Council of Economic Advisers and as Special Assistant to the President for Economic Policy. The study was reviewed by Professor Deborah J. Lucas, Household International Professor of Finance, Department of Finance, J.L. Kellogg Graduate School of Management, Northwestern University, and Professor Stephen Zeldes, Benjamin Rosen Professor of Economics and Finance at Columbia University's Graduate School of Business, and chair of the school's Economics Subdivision.

**The INFORUM Model, developed and maintained by economists at the University of Maryland, is one of the leading econometric models of the U.S. economy. The INFORUM Model is highly regarded for its simulation properties and its ability to capture the likely economic impacts of policy changes.

trating risk within a limited number of counter-parties needs to be carefully considered before any fundamental change of this type is considered. Moreover, it is simply not possible to truly immunize, because pension liabilities that depend on life expectancy cannot be hedged with bond portfolios. While this may be less of an issue for very large plans with large pools of participants, it would be a very significant problem for small and mid-sized plans. Since retirement plan liabilities depend in part on business prospects affecting when individuals retire, including elections of early retirement subsidies, it is impossible to precisely calculate the duration of plan liabilities.

More importantly, if a fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it could have a marked effect on the stock market, the capital markets, and capital formation generally. These effects need to be carefully considered because the consequences could be staggering. The volume of defined benefit plan assets held in equities is substantial. At the end of 2003, private-sector defined benefit plans held equities worth about $900 billion, compared with total U.S. equity capitalization of about $15 trillion. This represents more than 6 percent of equity market capitalization. There is no historical experience with a portfolio shift of this magnitude to serve as a guide, and the market impact is extremely difficult to predict. In general, an effectively forced sale of equities into bonds would work in the direction of depressing stock prices and raising bond prices. Higher bond prices would push down yields, further compounding the funding pressure, because lower stock prices would depress asset valuations and lower bond yields would increase plan liabilities.

Eliminating barriers to pre-funding

One aspect of the administration's proposal that we strongly support is the proposal to reform the tax rules governing the deductibility of pension plan contributions. We are pleased that this committee has previously approved improvements in the deduction rules. Existing tax rules that prevent employers from making pension contributions at appropriate times during the business cycle must be eliminated. Employers need to be able to fund up their plans when they have the capacity to do so.

We support increasing the deduction limit to 130 percent of liability. Equally important, we note that the combined plan limit on deductible contributions, which limits the deductions for an employer who maintains both a defined benefit and a defined contribution plan, needs to be adjusted. Otherwise, the current 25 percent of compensation rule will inappropriately limit deductible contributions for plans with large retiree populations relative to the current working population. In addition, we strongly recommend repealing the excise tax on nondeductible contributions. Finally, we recommend providing employers with flexibility in timing the year in which deductions are claimed. Under present law, pension contributions can be deductible in the year of contribution or, in the case of contributions made before the due date for the prior year's return (including extensions), the prior year. This inflexible rule can prevent adequate funding. For example, an employer with expiring foreign tax credits may have little choice economically but to defer pension contributions for a year, in order to keep its taxable income high, which is a bad policy result. By allowing corporations greater flexibility on when to deduct, they will be more likely to contribute when they can and will be less worried about corporate tax capacity.

Encouraging advance funding

We are also concerned about elements of the administration's funding proposal that could discourage employers from contributing more than the minimum required contribution. Under current law, if a company makes a contribution in excess of the minimum required contribution, the excess plus interest can be credited against future required contributions. This credit for pre-funding helps to mitigate volatile and unpredictable funding requirements by allowing and encouraging a sponsor to fund up during good times. The proposal, however, does not give employers who prefund direct credit for their excess contributions.

There have been suggestions that the current-law credit balance system has been a factor in terminating plans assumed by the PBGC. These suggestions ignore the fact that, but for the credit balance system, companies would have contributed less, resulting in more under-funding and more liabilities assumed by the PBGC. Critics have also pointed out that credit balances are not immediately adjusted if the underlying value of the assets decreases. Consequently, plans with poor investment results have been able to use credit balances that no longer exist to meet their minimum required contributions. We support carefully targeted reforms that address

this investment result problem. These reforms must be administrable and need to be applied prospectively. It would be fundamentally unfair to change the rules retroactively for employers that made contributions in reliance on current-law credit balance rules. It is critical, however, that we preserve appropriate incentives to advance-fund. Without these incentives, there is a significant risk that employers will only pre-fund to the minimum required by law. The result would be a less well-funded system, which is in no one's interest.

Avoiding unnecessary bankruptcies

Another issue that has been raised is whether it is prudent or feasible to base a retirement plan's rules on the determination of the creditworthiness of the plan sponsor and the members of the sponsor's controlled group. The PBGC has proposed basing funding, PBGC premiums, and the benefits a participant can receive on credit ratings. In effect, the employer's liability is treated as increasing when the employer's credit rating slips, even though the plan's benefit payment obligations remain unchanged.

The use of credit ratings to determine funding or PBGC premium obligations could have significant macroeconomic effects. Such use would put severe additional pressures on employers experiencing a downturn in their business cycle. If the lower credit ratings create additional funding burdens and business pressures, that could lead to further downgradings, creating a vicious circle that drags a company down. This could well happen to a company that today is able to fund additional contributions to pull itself out of the under-funding problem and thus raise its credit ratings. In short, a creditworthiness test would make it more difficult for a struggling company to recover. That is not in anyone's interest, including the PBGC, which could be forced to assume plan liabilities if the company does not recover. We must be careful not to lose sight of the fact that the best insurance for plans, participants and beneficiaries, and for the PBGC is a healthy plan sponsor.

It is also clear that the PBGC's proposal would classify many plans as at risk that will never be terminated. The mere fact that a company's debt is not rated as investment-grade does not mean that it will terminate its plans. However, the consequence of these "false positives" could well be self-fulfilling, with employers forced to terminate as a result of a downward spiral. Moreover, employers that have non-investment-grade debt but are improving their situation would get no credit for such improvement.

In addition, there are only a handful of credit rating entities, and we are also concerned that a creditworthiness test would inappropriately vest these entities with enormous power. This is particularly troubling at a time when the credit rating agencies, and the credit rating process itself, have been the subject of significant criticism. These criticisms have raised questions about the credibility and reliability of credit ratings. In this context, a creditworthiness test is ill-conceived.

Finally, we also note that a creditworthiness test would inevitably result in the government determining the creditworthiness of at least some American businesses. Many privately held employers are not rated by any of the nationally recognized agencies, and the PBGC has recommended conferring regulatory authority to develop guidelines for rating private companies. This would be unprecedented.

It is also important to recognize that an employer's credit rating is not directly tied to the plan's ability to provide the promised benefits. The plan is a separate entity, and one of the hallmarks of U.S. pension law is that pension assets must be held in a separate trust or similar dedicated vehicle. A plan that has assets sufficient to pay benefits will pay those benefits even if the plan sponsor does not have adequate assets to pay its debts or otherwise has debt that is rated below investment grade.

Providing timely and appropriate disclosure

We believe that participants should have timely and high-quality data regarding the funded status of their plans. It is important that participants have the information they need to evaluate their retirement security. These rules should be structured to provide full and fair disclosure without creating undue administrative burdens on plans or causing unnecessary concerns among participants.

In this context, existing disclosure requirements should be enhanced, while at the same time avoiding the creation of costly and confusing new requirements. Such an approach avoids the significant burdens of providing new documents to participants. A starting point might be the administration's general proposal to improve the summary annual report ("SAR"), but with significant modifications that would make the information disclosed more immediate and more meaningful. One of the problems with the SAR under current law is that the information disclosed is not timely, a problem which is not addressed by the administration's proposal. In fact, currently,

the information provided can be almost 2 years old. Accordingly, we would propose stronger changes.

All plans could be required to disclose in the SAR their funded percentage on a current liability basis. However, instead of reporting percentages as of the first day of the plan year for which the SAR is provided, the percentage could be reported as of the first day of the following year, using (1) the fair market value of assets as of that date and (2) the liabilities as of that date based on a projection from the preceding year. A plan maintained by a public company could also be required to disclose the year-end funded status of the plan as determined for purposes of financial accounting for the 2 most recent years available.

This approach would provide much more information than under present law or under the administration's proposal. Information would also be based on the fair market value of plan assets, as well as a timely current interest rate in the case of financial accounting information. In addition, unlike the administration's proposal, financial accounting information that is already circulated and disclosed could be used. By using information available to employees through financial reports and media statements, the possibilities for confusion would be greatly reduced.

Funding the PBGC appropriately

The PBGC has openly stated that premium increases are in large part needed to fill the PBGC's deficit. While we fully agree that the PBGC has a significant deficit, the $23 billion figure overstates the problem, and the required premium increases are, at best, premature and excessive. In addition to the fact that we continue to be in a period of historic low interest rates—rates that temporarily inflate PBGC's liability—, the PBGC uses an even lower interest rate (roughly 4.8 percent) to value its liability, thereby overstating its liability as well as ignoring possible future PBGC investment gains.

While we believe that reform is needed to address the growing deficits at the PBGC, we feel that the best way to deal with that problem is to keep more employers in the system, not to tax them out of the system. The PBGC proposes unprecedented increases in premiums, including a 60-percent increase in the flat-rate premium, plus guaranteed future flat-rate premium increases and effective increases in variable-rate premiums, which many more plans would have to pay given the much larger definition of liability.

These massive premium increases would put a huge strain on plans. The PBGC's unprecedented proposal to index the flat-rate premium for wage inflation, guarantees ever-escalating PBGC premiums for all employers, even if the agency does not require the funds. In addition, the PBGC's unprecedented proposal to allow its board to set variable premiums would make it impossible for plan sponsors to predict premiums from year to year. Rising and uncertain premiums will force many plan sponsors, including especially small employers, to exit the system.

Confirming the legality of hybrid plan designs

Hybrid defined benefit pension plans, such as cash balance and pension equity plans, were developed to meet the needs of today's mobile workforce by combining the best features of traditional defined benefit plans and defined contribution plans. Nearly a third of large employers with defined benefit plans maintain hybrids, and, according to the PBGC, there are more than 1,200 of these plans providing benefits to more than 7 million Americans as of the year 2000. These plans are defined benefit plans, and many of the same funding issues described above are relevant. They also face unique issues.

Despite the significant value that hybrid plans deliver to employees, current legal uncertainties threaten their continued existence. As a result of one court decision, every employer that today sponsors a hybrid plan finds itself in potential legal jeopardy. It is critical that this uncertainty be remedied, and pension reform legislation needs to clarify that the cash balance and pension equity designs satisfy current age discrimination and other related ERISA rules. In addition to clarifying the age-appropriateness of the hybrid plan designs, we believe it is essential to provide legal certainty for the hybrid plan conversions that have already taken place. These conversions were pursued in good faith and in reliance on the legal authorities in place at the time.

Some in Congress are seeking to impose specific benefit mandates when employers convert to hybrid pension plans. For example, some would require that employers pay retiring employees the greater of the benefits under the prior traditional or new hybrid plan. Others would require employers to provide employees the choice at the time of conversion between staying in the prior traditional plan or moving to the new hybrid plan. We strongly urge you to reject such mandates. Inflexible mandates will only drive employers from the system and reduce the competitiveness

of American business. Employers must be permitted to adapt to changing business circumstances while continuing to maintain defined benefit plans.

CONCLUSION

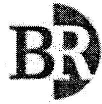
In evaluating any change, the interests of tens of millions of American workers and retirees who rely on the private pension system as a critical element of their retirement security must remain paramount. Two badly needed changes must be enacted quickly to preserve that system. The first is the permanent adoption of the long-term corporate bond rate. The second is a rational framework for hybrid plans. There is substantial agreement on the need for both of these changes.

Given the size of private pension plans in the U.S. economy and the value of pension plans relative to other company assets, the consequences of other pension changes could be harmful for both the U.S. economy and American workers. Pension reform must not disrupt economic growth critical to workers, retirees, plans, companies or the PBGC. In particular, we are concerned that certain changes could have serious unintended macroeconomic costs.

- *Spot rates exacerbate economic downturns and job losses.* Proposals that move to a spot rate to value pension liability could intensify the cyclical nature of the U.S. economy—deepening economic downturns and increasing job losses during recessions. A spot rate would cause pension liabilities to rise during recessions, forcing employers to make larger contributions and cut investment spending when the economy is at its weakest. We are very concerned that reductions in investment spending would deepen recessions and slow job growth.
- *Volatility compromises long-term business planning.* Use of a spot interest rate to value pension liability and mark-to-market treatment of assets would also make the funding rules even more volatile and unpredictable, without improving accuracy or plan funding. This could severely handicap the ability of employers to make long-term business plans. Proposals to eliminate credit balances, which provide a cushion against unpredictable volatility, would exacerbate this problem.
- *Excess contributions undermine investment and economic growth.* Requiring contributions in excess of what is reasonably and realistically needed to fund promised benefits could be incredibly disruptive to the economy, draining capital that would otherwise be used for investment and growth.
- *Proposals could cause unnecessary bankruptcies.* Proposals that base contributions and PBGC premiums on credit ratings would create the potential for a vicious downward corporate spiral. If lower credit ratings create additional funding burdens and business pressures, that could lead to further downgrades, creating a circle that drags a company down that would otherwise recover. We are concerned this type of spiral could be disastrous for American workers and the economy. Similarly, for some employers, the increased cash flow burden associated with sudden inflated contribution obligations could force unnecessary bankruptcies, with devastating consequences for workers and our economy.

We believe that reforms are needed to strengthen the system but that reforms will require considerably more discussion to avoid unintended results. We have outlined a number of specific ideas above, and we urge the committee to consider them.

Mr. Chairman and members of the committee, we thank you for the opportunity to present our views. We look forward to working with the committee and the administration on a comprehensive discussion of the long-term funding challenges facing our pension system, as well as proposals designed to provide additional protection to the PBGC.



Business Roundtable

Pension Smoothing Changes Would Worsen Job Losses in Recessions

An Analysis for the Business Roundtable
Pension Reform Study Group

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February 28, 2005

*This study has benefited from review and comments by Professor Deborah J. Lucas, Finance Department, Kellogg Graduate School of Management, Northwestern University; and Professor Stephen P. Zeldes of Columbia University's Graduate School of Business.

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Executive Summary

- Shortening 4-year pension smoothing for defined-benefit pension plans would intensify the cyclical nature of the U.S. economy, deepening economic downturns and increasing job losses during recessions. In 2003 alone this change would have cost the U.S. more than 300,000 jobs.

- Current defined-benefit pension plan rules specify the use of a 4-year moving average of the yield on long-term bonds to calculate current pension liabilities. The effect of this smoothing is to avoid wide swings in current liability calculations as interest rates vacillate. This smoothing allows pension calculations to follow economic trends, but eliminates anomalous high and low points for these long-term pension investments.

- Current Administration proposals to eliminate smoothing and move to a 90-day spot rate would cause current liability calculations to rise during recessions, forcing employers to make larger pension contributions and cut investment spending when the economy is at its weakest. These reductions in investment spending would deepen recessions and slow job growth.

- If a 90-day spot rate had been in effect over the past few years, a respected independent econometric model of the U.S. shows :

    - There would have been 83,000 fewer payroll jobs in 2001; 172,000 fewer jobs in 2002; and 330,000 fewer jobs in 2003.

    - The unemployment rate would have been 0.1 percentage point higher in 2001 and 2002, and 0.2 percentage point higher in 2003. Instead of an actual unemployment rate of 6.0% in 2003, for example, it would have been 6.2%.

    - Real GDP would have been reduced by 0.1% in 2001 and 2002, and by 0.24% in 2003.

- To put these numbers in perspective, the U.S. economy added 93,000 jobs in 2003; with a shift to a 90-day spot rate, the economy instead would have suffered a job loss of 237,000 jobs.

- 4-year smoothing can ensure the same overall levels of pension funding over substantial periods of time as a 90-day spot rate.

A More Pro-Cyclical Economy with Deeper Recessions

More volatile funding requirements are costly for the U.S. economy and a wide range of stakeholders – including workers, investors and companies. Larger pension contributions are likely to reduce capital investment spending, which is an important component of aggregate demand in the U.S. macroeconomy.

- A forthcoming article in the *Journal of Finance* by Joshua Rauh of the Graduate School of Business at the University of Chicago finds that for each extra dollar of required pension contribution, businesses with defined-benefit pension plans cut back on their investment spending by 60 to 70 cents.[1]

- Lower investment spending has a multiplier effect on GDP. With less smoothing, temporary swings in financial markets would amplify the ups and downs of the U.S. economy and exacerbate worker layoffs in down cycles.

During recessions monetary authorities lower short-term interest rates causing bond yields to decline. The purpose of lowering interest rates is to trigger self-correcting economic forces. Lower interest rates (lower cost of capital, lower mortgage rates and lower consumer lending rates) tend to stimulate investment spending, boost new home construction, spur durable good sales and help the economy start to revive. However, a foreshortened pension-smoothing period would have the opposite effect and dampen economic improvement.

- With present 4-year smoothing of the defined-benefit discount rate, the computed discount rate tends to fall by a relatively small amount in recessions and the increase in the liability gap tends to be damped. This moderates the need for pension contributions in recessions and makes more funds available for investment spending.

- With a 90-day spot rate – as in the Administration's current policy proposal – the estimated liability gap would increase faster in recessions as interest rates fall. This would partially offset the normal self-correcting force of lower interest rates.

- With the Administration's proposed 90-day spot rate, these pro-cyclical forces would also cause the economy to overheat even more in boom times. When the economy is booming and interest rates are normally high and increasing, less smoothing would mean the use of a higher interest rate for discounting purposes. This would reduce liabilities, cut pension contributions and boost investment spending—setting the economy up for a harder crash landing later and making the job of monetary authorities that much more difficult.

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[1] In this forthcoming paper entitled, "Investment and Financing Constraints: Evidence from Funding Corporate Pension Plans," Rauh argues that companies that do not maintain DB plans might step up their investment spending and provide a small offset—but no more than about 12 percent of the investment reduction. He concludes that most of the foregone investment is not recouped and is "gone forever."

Quantifying the Economic Effects of a 90-Day Spot Rate

It is possible to estimate how a shift to the Administration's proposal of a 90-day spot rate, (rather than the present 4-year smoothing), might have affected the U.S. macroeconomy in recent years. Table 1 relies on historical bond yields and shows that current liability calculations would have been sharply higher for a typical pension plan during the period 2001-03, had a 90-day spot rate been in force instead of the actual 4-year smoothing.

These percentage changes in current liabilities can be used to estimate the impact of smoothing on the liability gap—the difference between the present value of liabilities and assets. Based upon an average duration of defined-benefit liabilities of 12-13 years and an average duration of assets of 5-6 years, the liability gap would have increased for the years 2001-03 as shown in Table 2.[2] This table also presents an extrapolation of the effect on the liability gap on the whole U.S. defined-benefit pension system (about $1.8 trillion in total liabilities in 2002), had a 90-day spot rate been in force. Assuming 40 cents of extra pension contributions for each extra dollar of liability gap, such contributions would have been $15.3 billion higher in 2001, $12.5 billion higher in 2002 and $26.6 billion higher in 2003 if a 90-day spot rate had been in effect instead of the actual 4-year smoothing.

Table 1: *Pension Current Liabilities with 90-Day Spot Rate: Percent Difference from the Current Law with 4-Year Smoothing*

Quarter	90-day instead of current 4-year smoothing, % effect
2001 Q1	4.6%
2001 Q2	2.9%
2001 Q3	2.3%
2001 Q4	4.9%
2002 Q1	3.0%
2002 Q2	-0.9%
2002 Q3	2.6%
2002 Q4	6.6%
2003 Q1	6.4%
2003 Q2	8.1%
2003 Q3	5.7%
2003 Q4	1.5%

Note: Current law assumes 4-year smoothing of 30-year U.S. government bonds, with weights of 4,3,2,1 for previous four years.

[2] Defined-benefit equities are estimated to have an average duration of 5 years (Risk-Metrics estimate), and defined-benefit bond holdings have a typical duration of 5-6 years (CIEBA survey), so overall average asset duration is 5-6 years. Given these durations, the present value of liabilities minus assets would move by about 7/12 as much as the change in current liabilities.

- Based upon Rauh's most conservative estimate (that each extra dollar of pension contributions reduces capital spending by 52.8 cents[3] on net), this exercise suggests that with a 90-day spot rate, capital spending would have been $8.1 billion lower in 2001, $6.6 billion lower in 2002 and $14.1 billion lower in 2003.

- In percentage terms, this would have represented reductions in economy-wide capital spending of about 0.7 percent, 0.6 percent and 1.3 percent in 2001, 2002 and 2003.

Table 2: *Hypothetical Effects of a 90-Day Spot Rate for Current Liabilities on Liability Gap and Capital Spending (vs. Current 4-Year Smoothing)*

Year	Potential % Change in Liability Gap	Potential $ Change in Liability Gap	Potential Reduction in Capital Spending	Potential % Reduction in Capital Spending
2001	2.1%	$38 billion	$-8.1 billion	-0.7%
2002	1.7%	$31 billion	$-6.6 billion	-0.6%
2003	3.2%	$67 billion	$-14.1 billion	-1.3%

Assumptions: 1) pension contributions equal 40 percent of changed liability gap, and 2) investment declines by 52.8 cents for each dollar increase in pension contributions.

Estimating the Effects on the Whole U.S. Economy

Econometric models are statistical representations of the U.S. economy and can be used to quantify the effect of policy changes and economic shifts on real gross domestic product (GDP), employment, unemployment and inflation. Such models are solved using iterative solution algorithms, so changes in activity or behavior that begin in one sector of the economy (say, corporations that cut back on investment spending), then have feedback effects on other sectors of the economy. One of the leading econometric models of the U.S. economy is the INFORUM Model developed and maintained by economists at the University of Maryland. This model is highly regarded for its simulation properties and its ability to accurately capture the likely economic impacts of policy changes.

The above reductions in investment spending—induced by a potential reduction in the interest rate smoothing period from 4 years to 90 days—were imposed on the INFORUM Model for the years 2001-03. The model was then simulated to capture the likely ultimate economic impacts. The main results are presented in Table 3.

[3] This is Rauh's estimate of a 60 cent reduction in investment spending adjusted for a 12% offset by firms that do not maintain defined-benefit plans and that might increase their investment spending to take advantage of projects that firms with defined-benefit plans cannot afford.

Table 3: *University of Maryland/INFORUM Econometric Model Simulation Showing Economic Effects of Shift from 4-Year Smoothing to a 90-Day Spot Rate*

	2001	2002	2003
Model Input			
Initial Reduction in Investment (difference in %)	-0.7%	-0.6%	-1.3%
Model Output			
Level of Real GDP (difference in % point)	-0.1%	-0.1%	-0.24%
Level of GDP (difference in bil. current $)	-$11.6	-$19.2	-$34.4
Level of Potential GDP (difference in % point)	0.0%	-0.1%	-0.2%
Level of Investment (difference in bil. current $)	-$8.5	-$9.6	-$21.4
Payroll Employment (difference in number of jobs)	-83,000	-172,000	-330,000
Unemployment Rate (difference in % point)	+0.06	+0.12	+0.23
Real Disposable Income (difference in % point)	-0.01%	-0.05%	-0.12%

These results suggest that a shift from 4-year smoothing of the interest rate used to calculate current pension liabilities to a 90-day spot rate would have had substantial negative consequences for the U.S. during 2001-03.

- The level of real GDP would have been lower—by 0.24% by 2003—and the level of nominal GDP would have been lower by nearly $35 billion.

- Investment would have been more than $20 billion lower by 2003 with a 90-day spot rate—greater than the initial reduction in investment spending because the "feedback" effects from initially lower investment would have weakened the economy as a whole; and, as a result of this generally weaker economy, firms subsequently would have decreased their investment spending even more.

- With the weakening economy and additional uncertainty, labor markets would have been hurt significantly. In 2001 payroll employment would have been lower by 83,000 jobs; by 2003 about 330,000 jobs would have been lost.

- The unemployment rate would have been about one tenth of a percentage point higher in 2001 and 2002, and more than two tenths of a percentage point higher in 2003. For example, instead of an actual unemployment rate in 2003 of 6.0%, the simulation shows that it would have been 6.23% if a 90-day spot rate had been in effect.

These results would be more or less symmetrical in economic boom phases. Without smoothing, the interest rate used to discount pension liabilities would be higher and required pension contributions would be lower. As a result, investment spending would be even higher in boom times, so potentially there could be some investment catch up. However, stimulating more investment spending during economic booms is not a generally desirable macroeconomic goal. Such a boost to investment is likely to cause the economy to overheat even more than it otherwise would, boost inflation to even more unhealthy levels and complicate the task of economic policymakers.

Still Maintaining Pension Plan Integrity

It is important to note that the financial integrity of defined-benefit pension plans can still be maintained even without the forced higher pension contributions that would be required in recessionary periods by a 90-day spot rate. As interest-rate movements average out over substantial periods of time, 4-year smoothing can still ensure the same overall levels of pension funding as a 90-day spot rate, but with less disruptive pro-cyclical tendencies.

Conclusions

A shift to a 90-day spot rate would have deepened the 2001 recession and cost substantial numbers of Americans their jobs in 2001, 2002 and 2003. Employment in 2003, for example, would have been 330,000 jobs lower without smoothing. These reductions in investment and employment would have represented noticeable negative effects and would have offset roughly one third to one half of the stimulative effects of the tax cuts during these years that were included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Lower investment spending would have taken a toll on the ability of the U.S. economy to grow faster in the future. Potential GDP, a measure of the economy's capacity to grow in the future without generating accelerating inflation, would have been lower by 0.2% by 2003, and more than 0.4% in 2004 and 2005. This is because fewer machines and capital tools being added by U.S. businesses in 2001-03 would have left the economy with less capacity to generate new wealth in the future—a persistent drag on the well-being of American households and a negative legacy effect of a shift to a 90-day spot rate.

In any case, over a substantial period of time, 4-year smoothing could keep pension plans just as financially healthy as would reliance on a 90-day spot rate, but without making the U.S. economy unnecessarily pro-cyclical.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: You referenced a study that shows a significant loss of jobs would have occurred in 2003 if the spot rate had been in effect instead of a current 4-year weighted average.

Did the study distinguish between the impact of the yield curve and the increased contribution requirements for non-investment-grade companies? If so, what was the impact of the different components?

Answer: We have attached a copy of the study for your consideration. The study is an "apples to apples" comparison of the administration's spot rate proposal to the current 4-year weighted averaging mechanism. It evaluates the probable economic effects if the administration's 90-day spot rate been in effect rather than the 4-year weighted average rate that was in effect. To this end, the study compares contributions made using the 4-year weighted average of the 30-year Treasury bond rate (the interest rate in effect during the relevant years) to the contributions that would have been made had the 90-day average of the 30-year Treasury bond rate been in effect. As a result, the effects of the yield curve and the increased contribution requirements for non-investment-grade companies are not reflected in the job loss numbers. It is reasonable to assume that the job loss numbers would have been significantly worse had those requirements been in effect, but we have not conducted a study on the macroeconomic effects of those requirements.

Question: Would the ability to make higher contributions in good times have affected the results of the study?

Answer: It is not clear that the administration's proposal actually permits higher contributions during good times. The administration's proposal could severely restrict funding relative to current law during higher interest rate environments. In addition, the administration has not proposed modifying or eliminating the combined plan limit restricting deductible contributions to 25 percent of compensation, which would preclude many employers with significant retiree populations from building a funding cushion. Similarly, the administration's proposed elimination of the credit balance system would discourage pre-funding. That said, if companies had the ability to make higher contributions in good times and build a "funding cushion," this cushion would have reduced the contributions required during the depths of the economic downturn. It makes sense that this would have softened the downturn and saved jobs, but the extent of the improved job numbers would depend on the degree to which employers in fact made higher contributions.

Question: Would the retention of the credit balance system have affected the results of the study?

Answer: The study does not take into account the effects of the current credit balance system. However, credit balances mitigate funding volatility and help employers to weather economic downturns. As a result, it seems likely that the administration's proposed elimination of the current-law credit balance system would have resulted in greater job loss during the downturn from 2000–2003. However, we have not attempted to quantify the role credit balances play in mitigating recessions and keeping the economy from overheating.

RESPONSES TO QUESTIONS FROM SENATOR HATCH

Question: Mr. Zimpleman, you mentioned in your statement that any reforms accomplished this year should not drive employers out of the pension system. Do you believe any part of the administration's proposal would result in plans being frozen or terminated?

Answer: We have serious concerns about many elements of the administration's proposal. Our primary concerns are that the proposal would (1) drastically restrict the predictability of funding and premium obligations through spot valuations of liabilities and assets; (2) introduce a counterproductive and troubling use of credit ratings; (3) create a strong disincentive to pre-fund through the complete elimination of credit balances; and (4) burden the defined benefit plan system with PBGC premium increases that are not warranted. We fear that the net result would be fewer defined benefit plans, lower benefits, and far more pressures on troubled companies that jeopardize the companies' ability to recover.

Quesion: What is the most important single thing Congress should do this year to keep the DB pension system viable?

Answer: The best way to protect pensions for future retirees and working Americans is for Congress to enact permanent rules that lead to a fair and stable system. The unexpected termination of the 30-year Treasury bond in 2001, and the subsequent temporary fixes to the interest rate used for pension calculations have made it impossible for employers to project future pension contributions. Congress should make permanent the long-term corporate bond rate adopted last year on a tem-

porary basis. The long-term corporate bond rate provides a realistic picture of future pension liabilities and is the best measure to ensure the adequacy of pension funds for future retirees. In addition, uncertainty regarding the status of cash balance and other hybrid plans is stifling innovation and flexibility in pension plan design. Affirming the legality of these plans is a necessary step to a vibrant defined benefit system.

Question: From a theoretical standpoint, is there anything deficient with the administration's yield curve?

Answer: We have concerns about five aspects of the administration's "yield curve" proposal. First, the administration's yield curve interest rate is a "spot rate" rather than a 4-year weighted average rate. It will eliminate current-law smoothing of interest rates and saddle employers with unpredictable funding obligations. Second, the yield curve proposal would apply different interest rates to different payments to be made by the plan based on the date on which that payment is expected to be made. This is an unnecessarily complex methodology. Third, we are concerned that the administration's mechanisms for creating interest rate assumptions would require excessive and unnecessary contributions for some mature plans, which could be very harmful for employers, workers, and the economy. Fourth, the proposed yield curve is opaque because it is not an interest rate that is available in the marketplace. The yield curve is constructed by the Treasury Department using as much art as science, and it will be very difficult for businesses to use in long-term planning as well as for Congress to oversee. Finally, we are concerned that the yield curve would improperly understate liabilities and restrict funding during higher interest rate environments. Current law requires companies to make contributions equal to the greater of contributions required under the deficit reduction contribution rules or the ERISA funding rules. The ERISA funding rules, which the administration would repeal, ensure that companies properly fund their plans during all economic environments.

COMMUNICATIONS

AMERICAN BENEFITS COUNCIL

March 1, 2005

The Honorable Charles E. Grassley
Chairman
United States Senate
Committee on Finance
215 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

We wish to thank you for holding this hearing on proposals for improved funding of private sector pension plans. We hope the hearing will address the advantages that these plans provide to both employers and employees. The discontinuance of the Treasury Department's 30-year bond in late 2001 has had a dramatic impact on defined benefit pension plans across the nation. In April 2004, you played a key role in enacting a temporary replacement rate for the 30-year Treasury bond based upon long-term, high quality corporate bonds and we are grateful to you for your work on that legislation. Accordingly, we respectfully submit to you that the long-term corporate bond should permanently replace the 30-year Treasury bond. This and many other recommendations are outlined in the material we are submitting for the hearing record.

The American Benefits Council is a public policy advocacy organization representing over 250 organizations whose members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans. Our purpose is to provide in-depth information, analysis and opinion of the current legislative and regulatory situations and emerging trends in employee benefits policy.

The vast majority of our members sponsor at least one defined benefit pension plan. Some of our members sponsor numerous plans for their employees. These plans hold many billions of dollars in assets. Our members continue to sponsor these plans despite the trend among many companies to discontinue sponsorship of their defined benefit plans. As a consequence, our members have a strong interest in any legislative consideration of defined benefit pension plan funding. Any changes to pension plan funding that would unduly burden corporate sponsors or discourage continued sponsorship of these plans are not merely bad for corporate America, they are bad for American workers and retirees.

As of 1999, (the most recent year for which official Department of Labor statistics have been published) more than 20 million retirees were receiving benefits from defined benefit pension plans, with over $119 billion in benefits paid out in that year alone[1]. These payments are not only good for the individuals who received them, they are also good for the American economy. Through these retirement payments, money that was once scored as "lost revenue" is returned to the economy as retirees purchase goods and services, pay their bills and mortgages, and best of all, maintain their standard of living during their post-employment years.

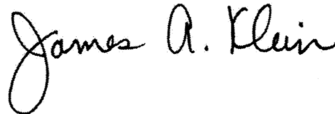
We take very seriously, however, news reports regarding failures of certain pension plans and we believe that reform of the current system is needed. However standards for funding should not be set so high that they make plan sponsorship unaffordable. The objective of reform cannot simply be immunization of the Pension Benefit Guaranty Corporation (PBGC). It must make the defined benefit pension plan system healthier and more vibrant, as well.

In analyzing the effects of any funding reform recommendations, it is important to bear in mind that current law does not now, nor should it ever, require an employer to sponsor a benefit plan as a condition of being in business. If the government imposes excessive burdens on a benefit voluntarily provided, employers will have little choice but to discontinue them at their earliest possible convenience.

The American Benefits Council respectfully submits the attached report, "Funding Our Future," for the record of this hearing. This report was recently published by the Council. It was developed by the member companies of the Council over many months of study and consultation. We understand that the committee requests that testimony not exceed 10 pages in length, however we ask that you waive this requirement.

We thank you for the opportunity to submit these comments to you and the Members of the Senate Finance Committee. If you would like to discuss these matters further, please do not hesitate to contact us.

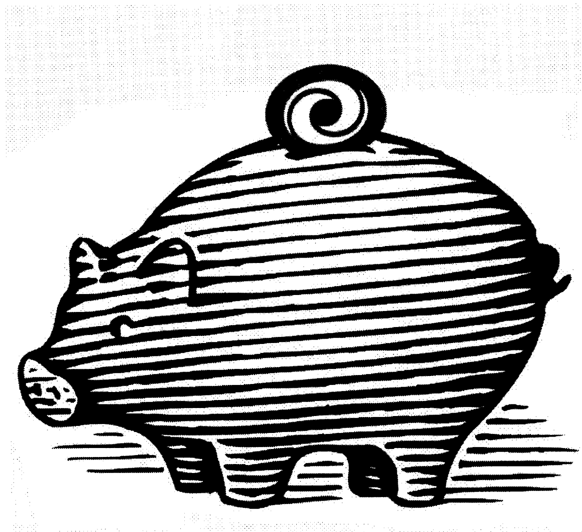
Sincerely yours,



James A. Klein
President

[1] U.S. Department of Labor, Employee Benefit Security Administration, *Private Pension Plan Bulletin*, Number 12 summer 2004, pages 8, 10.)

Funding our Future:



A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform

AMERICAN BENEFITS COUNCIL

February 2005

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FOREWORD

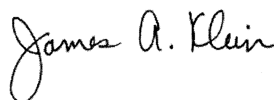
At its October 2001 meeting, the Board of Directors of the American Benefits Council identified as an urgent priority the need for replacement of the 30-year U.S. Treasury bond interest rate used for defined benefit pension plan funding and other purposes.

Over the subsequent several months the Council, working in concert with other like-minded organizations, identified a long-term investment grade corporate bond rate as the appropriate permanent replacement rate. The Council has testified before Congress numerous times over the past few years on the need for replacement of the interest rate and other related pension funding reforms. The Council's work in recent years follows a long tradition of engagement on legislative reform efforts to improve pension funding, better secure the financial integrity of the Pension Benefit Guaranty Corporation (PBGC) and advocate for policies that will protect and promote defined benefit pension plans.

In 2004 Congress passed, and President Bush signed, legislation that addressed, on an interim basis, the need for replacement of the interest rate used for plan funding calculations. This year with the temporary legislation expiring and with heightened concerns over pension funding and the liabilities inherited by the PBGC, it is clear that broader pension reforms should and will be a priority issue for the Congress and the executive branch.

The American Benefits Council has drawn upon the expertise and varied perspectives of its corporate membership, and developed what we firmly believe is a safe and sound approach to defined benefit pension plan funding. In addition to setting forth our own proposals, this document also critiques many of the Administration's proposals and indicates the principal areas where our views and Administration's are aligned, and where they differ. This analysis is based upon a review of the Administration's detailed proposals that were made available in early February as a comprehensive follow-up to the Administration's initial proposals previously released.

With adoption of the American Benefits Council's recommendations set forth in this paper, policymakers will take crucial steps toward *"Funding our Future."*



James A. Klein
President
American Benefits Council

FUNDING OUR FUTURE:

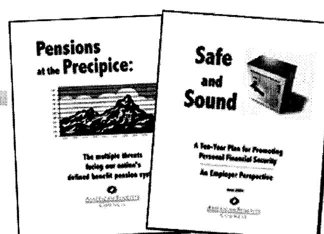
A SAFE AND SOUND APPROACH TO DEFINED BENEFIT PENSION PLAN FUNDING REFORM

INTRODUCTION

The American Benefits Council believes strongly in defined benefit pension plans. A recent Council publication enumerates in substantial detail the very serious challenges facing the defined benefit plan system. (See *Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System* (May 2004)).

Moreover, the Council also last year issued a comprehensive long-term public policy strategic plan, *Safe and Sound: A Ten-Year Plan for Promoting Personal Financial Security – An Employer Perspective* (June 2004) that discusses the importance of a vibrant employer-sponsored retirement system (both defined benefit and defined contribution plans) and personal savings in meeting the income security needs of an aging population.

As discussed in more detail in both the *Safe and Sound* strategic plan and the *Pensions at the Precipice* report, the Council believes several legislative steps are needed to revitalize and support the defined benefit pension system.



Among these legislative steps are reform of the funding rules so that:

(1) benefits promised to participants are funded, thus protecting participants and the Pension Benefit Guaranty Corporation (PBGC);

(2) funding obligations are neither artificially inflated nor volatile, thus preventing employers from abandoning the system because of adverse effects on business planning;

(3) plan participants are provided clear, timely information about the funded status of their plan; and

(4) the funding rules do not unreasonably increase burdens on companies during economic downturns, since the best "insurance" for participants' benefits is a healthy company that recovers from such downturns.

It is critical that reforms be focused on our ultimate goal: retirement security. Because of PBGC deficits, there is a risk that the reform efforts will be focused only on the PBGC.

While we wholeheartedly agree that the PBGC must be protected, it is critical that we not lose sight of the fact that the PBGC was set up to strengthen retirement security through the defined benefit plan system. In other words, if we protect the PBGC at the expense of the strength of the system, we will have failed in an ironic and sad manner.

The Administration has issued its funding and premium proposal. We believe that the proposal has strengths, but also has serious flaws that would have extremely adverse effects on plans, participants, companies, and the PBGC itself. The primary flaws of the Administration's proposal are:

If we protect the PBGC at the expense of the strength of the defined benefit pension plan system, we will have failed in an ironic and sad manner.

(1) a dramatic decrease in funding and premium predictability;

(2) a counterproductive and troubling use of credit ratings;

(3) creation of a strong disincentive to pre-fund; and

(4) an increase in PBGC premiums that unjustifiably burdens the defined benefit plan system.

We look forward to the opportunity to work with the Administration on its proposal. In its current state, however, we believe that the flaws noted above would result in far fewer defined benefit plans, lower benefits, and far more pressures on troubled companies that jeopardize the companies' ability to recover.

Our proposals

This paper outlines our proposals for funding reform for plans other than multiemployer plans. There is a threshold question as to whether reform should be based on modifications of current law or whether the current-law rules should be replaced in their entirety with a new structure. We support the former approach.

In a complex area that needs reform, there is always some temptation to throw out all the rules and to start from scratch. However, certainly in this case, that would be both unnecessary and imprudent. The funding questions that must be addressed are the same regardless of which path is chosen. For example, how should liabilities be measured; how quickly should underfunding be funded; what contributions should be deductible; and what disclosure should be required? Starting from scratch does not make answering questions like this easier. On the

contrary, starting from scratch makes it more difficult by requiring that all funding rules be reinvented in the new context. And the risks are far greater with wholesale reform because there will inevitably be issues missed, such as subtle important rules reflected only in regulations that are inadvertently omitted from the new regime.

Finally, modification of the current rules involves far less cost and disruption for plan sponsors. And it is critical to remember that this is a voluntary system. If plan sponsors face large and uncertain costs in adapting to an entirely new set of rules, many will abandon the defined benefit plan system.

In short, every important issue can be addressed by modifying the current rules without the uncertainty and cost of creating a whole new system.

Permanent Replacement of the 30-Year Treasury Rate

The long-term corporate bond rate
Prior to the Pension Funding Equity Act of 2004, the 30-year Treasury bond interest rate was required to be used to determine the "current liability" of a defined benefit plan. "Current liability" is, in turn, used in certain circumstances to determine how much the plan sponsor must contribute in a year to fund the plan. The 30-year Treasury bond interest rate was also required to be used for various other pension purposes, including determining the amount, if any, that is owed to the PBGC as a variable rate premium.

> "Permanent replacement of the 30-year rate is critical if employers are to create new jobs and help grow the economy."
>
> —*from the Council's* Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System

The 30-year Treasury bond rate has become artificially low compared to other interest rates because of Treasury's buyback program (which started in the late 1990s) and because of the discontinuance of the 30-year Treasury bond in 2001. The use of this low rate for pension purposes artificially inflates pension liabilities and funding obligations. If applicable, these inflated obligations will have adverse effects on the nation's economy.

In addition, concerns regarding unrealistic funding obligations have already led companies to freeze plan benefits and many more companies will likely do so if a permanent replacement for the 30-year Treasury bond rate is not enacted soon.

Congress recognized that the 30-year Treasury bond rate was a "broken rate" in 2004 and enacted a temporary solution, permitting the use of a

long-term investment grade corporate bond rate for 2004 and 2005. That was the right action at the time. Now is the time to make that change permanent.

Businesses need to be able to make projections about future cash flow demands so that they can make sound plans for the future. The temporary nature of the rule in effect today makes planning difficult and can undermine a company's commitment to the defined benefit plan system.

The Council strongly recommends that the 30-year Treasury bond rate be permanently replaced by the long-term investment grade corporate bond rate. As under current law and as discussed further below, for funding purposes, the four-year weighted average of such rate would be used.

The Administration's yield curve proposal does not reflect the real yield curve applicable to defined benefit plans.

This rate is a conservative estimate of the rate of return a plan can expect to earn and thus is an economically sound and accurate discount rate. In addition, it is a clear, simple rule that can be understood and administered easily by employers of all sizes.

The yield curve proposal

The Administration has proposed, as an alternative to the long-term corporate bond rate, a "yield curve." This proposal differs in two fundamental respects from the Council's proposal.

First, the yield curve interest rate is a "near-spot rate" rather than a four-year weighted average rate. This aspect of the Administration's proposal is discussed in a subsequent section of this paper.

Second, the yield curve proposal would apply a different interest rate to every expected payment to be made by the plan based on the date on which that payment is expected to be made. For example, the interest rate applicable to a liability to be paid in 19 years would be based on a 19-year corporate bond.

The yield curve proposal is flawed in several respects. First, the proposal would generate hundreds of different interest rates for *each* participant. This level of complexity may, at best, be manageable by some large companies; it would impose an unjustifiable burden on small- and mid-sized companies across the country.

Second, the proposal is intended to reflect the market and thus be "accurate;" in fact, the markets for corporate bonds of *many* durations are so thin that the interest rates used would actually need to be "made up," *i.e.*, extrapolated from the rates used for the other bonds.

Moreover, the Administration's proposal does not reflect the real yield

curve applicable to defined benefit plans. A real yield curve would reflect the fact that for long-term obligations, plans generally invest in equities in order to lower their costs (since over time equities earn a greater rate of return). For mid-term liabilities, plans generally invest in a mix of equities and bonds; plans invest more in non-equities for short-term liabilities.

Accordingly, if a real yield curve were used and it were simplified so that it could be administered by plans of all sizes, it might look something like the following:

Mid-term liabilities (*e.g.*, five to 20 years) would be valued based on the four-year weighted average of the long-term corporate bond rate; long-term liabilities (over 20 years) would be valued based on the four-year weighted average of the long-term corporate bond rate plus a specified number of basis points (such as 100); and short-term liabilities (less than five years) would be valued based on the four-year weighted average of the long-term corporate bond rate minus the same number of basis points.

The long-term liability basis point adjustment would reflect the fact that ongoing plans generally invest in equities to provide for long-term liabilities, and equities historically have a higher rate of return than long-term corporate bonds. The short-term basis point adjustment would reflect the fact that investments to meet short-term liabilities generally have a rate of return lower than long-term corporate bonds.

> "The yield curve should not be adopted, particularly in light of the many unanswered questions about the approach and the incomplete analysis of its ramifications on funding volatility and asset allocation."
>
> —*from the Council's* Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System

The Council strongly opposes the yield curve proposal, especially if it were to reduce the effective discount rate for the typical plan. Even the simplified version described above would introduce unnecessary complexity and disruption. The vast majority of plans would attain almost the same results using the long-term corporate bond rate alone; those few plans that would have a higher liability using the simplified yield curve are the most mature plans in industries that can least afford to have a sudden required increase in funding obligations.

Definition of Plan Liability

Use of "current liability" versus "termination liability"

As noted above, under present law, current liability is used for funding and other purposes. Current liability is a type of "snapshot liability," *i.e.*, it does

not include future liabilities based on future compensation or service. Current liability is, in this respect, similar to termination liability. Termination liability is the value of the benefits that would be owed if the plan terminated, measured using PBGC standards and assumptions. Some in the executive branch agencies have argued that current liability should be replaced or supplemented by termination liability; they argue that termination liability, which is greater than current liability, is the proper measure of a plan's liability.

For the vast majority of plans that are not terminating, the use of termination liability for funding and other purposes would be inappropriate and would grossly overstate plan liabilities. There are clear examples of this overstatement. Generally, under present law, the biggest difference between current liability and termination liability is the interest rate used to value liabilities.

The 'termination liability' interest rate developed by the PBGC is generally too low even for terminating plans.

For example, for October 2004, the four-year weighted average of the long-term corporate bond rate (which, as noted above, is used to determine current liability) was 6.21 percent; the termination liability interest rate developed by the PBGC for October 2004 was 4 percent for liabilities of 20 years or less and 5 percent for longer liabilities. The termination liability interest rate is far below even the 30-year Treasury rate, which was 5.14 percent (four-year weighted average) or 4.9 percent (spot rate) for October 2004.

The termination liability interest rate developed by PBGC is generally too low even for terminating plans, as will be addressed by a future Council paper. The numbers set forth above demonstrate that it is *extremely* low for an ongoing plan.

Termination liability also includes "shutdown benefits" and other similar "unpredictable contingent event benefits." Generally, those are additional benefits contingent on an adverse business event, such as the closing of the facility where a participant works. Because of the speculative nature of these benefits, they are very difficult to value and thus are not included in current liability. Without any practical way to value such contingent benefits, the Council opposes any proposal to include them in current liability.

The Council has reviewed the differences between current liability and termination liability and recommends that current liability be reformed in one significant respect for all plans (not just "at-risk plans"). Under present law, current liability is determined based on the assumption that all participants

receive their benefits in the form of an annuity.

To the extent that the plan offers lump sums, current liability should take into account lump-sum distributions reasonably projected to be taken (subject to a transition rule to prevent a sharp increase in current liability). For this purpose, reasonable projections could be made regarding the applicable lump-sum discount rates, provided that the projected discount rates may not be higher than the interest rate otherwise applicable in determining current liability.

The Administration's proposal would create a new type of termination liability for at-risk plans, based on the assumption that all employees take lump-sum distributions (to the extent available) and retire early. The lump-sum issue is discussed above. The proposed early retirement assumption would be unrealistic in the vast majority of cases, and would severely burden any "at-risk company," thereby jeopardizing the company's ability to recover. This is contrary to the interests of participants, the company, and the PBGC.

Preventing the Volatility that Would Be Created by Spot Valuations

From business' perspective, perhaps the most important issue relating to defined benefit plans is predictability.

Companies need to be able to make plans based on cash flow and liability projections. Volatility in defined benefit plan costs can have dramatic effects on company projections and thus can be very disruptive. It is critical that these costs be predictable.

The critical elements facilitating predictability under current law are:

(1) the use of the four-year weighted average of interest rates discussed above; and

(2) the ability to smooth out fluctuations in asset values over a short period of time (which is subject to clear, longstanding regulatory limitations on such smoothing).

The Administration has testified before Congress that the measurement of assets and liabilities should be based on spot valuations and that volatility can be addressed through smoothing contribution obligations. This approach is seriously flawed in three respects.

First, spot valuations are not necessarily accurate. For example, the spot interest rates from late 2002 were very poor indicators of interest rates for 2003. It simply is not logical to conclude that a spot interest rate for one short period is "the" accurate rate for a subsequent 12-month period.

Second, the Administration's proposal does not contain any smoothing mechanism to make contribution or premium obligations predictable.

Third, the Administration has not even acknowledged the *numerous* other rules that do not relate to contribution obligations that would become volatile if asset and liability measurements were based on spot valuations (*e.g.*, deduction limits, benefit restrictions). It is critical that the current-law smoothing rules be preserved.

Disclosure

The Council strongly supports enhanced disclosure of a plan's funded status. In fact, the Council's disclosure proposal would provide disclosure to more plans on a more timely basis than any other proposal (including the Administration's).

The current-law disclosure tool, the summary annual report (SAR), provides information that is almost two years old. That is inadequate. Under our proposal, within 2½ months after the end of the year, *all* plans would be required to disclose to participants year-end data on the plan's funded level.[1]

Year-end data would consist of year-end asset valuation, as well as beginning-of-the-year current liability figures projected forward to the end of the year, taking into account any significant events that occur during the year (such as a benefit increase). Plans would have the option to use year-end SFAS 87 data in lieu of the above data.

Other proposals achieve less disclosure, and some of the other proposals have serious adverse effects. Some proposals have been based on the SAR and thus give rise to disclosures that are out-of-date.

Other proposals require disclosure only from employers with plans that are more than $50 million unfunded. Those proposals are inadequate. For example, those proposals would not apply to a plan with $60 million of assets and only $20 million of liabilities. Moreover, those proposals inappropriately target large plans. A large plan that is 99 percent funded could be subject to disclosure under the proposals (*e.g.*, in the case of a plan with over $5 billion of liabilities) with the accompanying inappropriate stigma of being "so underfunded" as to be one of the few plans subject to this additional disclosure.

Certain executive branch agencies have discussed using termination liability (instead of current liability) for disclosure purposes, which is significantly higher than current liability. That could mislead and alarm participants in the vast majority of plans that are not terminating. The executive branch

[1] Because of the need to collect data from so many sources with different circumstances, more than 2½ months should be permitted for multiple employer plans and multiemployer plans.

agencies' concerns can be addressed, to the extent appropriate, by moving current liability closer to termination liability, as discussed above.

Critics of present law point out that although the vast majority of plans are ongoing, participants in plans that may well terminate in the near-term need information about their plans' funding status on a termination basis. We recognize this concern. We believe, however, that in conjunction with any expansion of the use of "termination liability," there would need to be a thorough reexamination of the assumptions used by PBGC to determine termination liability. As discussed previously, PBGC's assumptions are clearly unrealistic. These assumptions can have adverse effects on participants' benefits and should not be broadened in their application until corrected.

Even after the termination liability assumptions are corrected, we urge that any disclosure of termination liability be restricted to severely underfunded plans. As noted, in the case of a well-funded ongoing plan, disclosure of a plan's funded status on a termination basis will only alarm and mislead participants.

Finally, H.R. 5006 (the Labor-Health and Human Services appropriations bill, in the 108th Congress) would have required disclosure of confidential corporate information, pursuant to an amendment offered by Rep. George Miller (D-CA). This was clearly inappropriate and we assume unintended, as it departs sharply from the Administration's proposal on which it was expressly based.

Avoid Direct or Indirect Incentives to Move Plan Investments Away From Equities

There has been a significant amount of discussion by government officials and members of the media indicating that defined benefit plans should be invested in bonds rather than in equities. The bond proponents argue that this would address business' concerns with volatility, as well as protect PBGC and plan participants. In the strongest possible terms, the Council opposes any legal structure that penalizes plans for investments in equities. For the reasons discussed below, we believe that any such structure would be disruptive and harmful to plans, companies, participants, and the economy as a whole.

Effect on the markets

If a yield curve or other fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it would have a marked effect on the stock market, the capital markets, and capital formation generally. Hundreds of billions of dollars could move out of the equity markets with economic consequences that could potentially be staggering.

Effect on the cost of defined benefit plans

Over time, pension plans earn more on investments in equities than in bonds. If plan earnings decline because plans are compelled to invest in bonds or other low-yielding instruments, plans' overall costs will rise. As plans become more expensive, it goes without saying that there will be fewer plans and lower benefits in the plans that remain.

The myth of immunization

One primary argument made by the bond proponents is that plan investment in bonds can be used to "immunize" the plan with respect to its liabilities. The bond proponents contend that employers can insulate themselves from both volatility and liability by investing in bonds.

'Immunization' is theoretically viable until a company encounters difficulties, at which time it will *inevitably* become underfunded.

First, it is far from clear that there could ever be enough bonds or other instruments available to permit plans to immunize in this manner. But even if there were enough, the immunization arguments do not hold up to scrutiny. When asked, even the staunchest bond proponents admit that there are numerous pension liabilities that cannot be immunized. For example, because mortality cannot be predicted with precision, it is not possible to immunize a plan that makes life annuity payments. Even more problematic are early retirement subsidies. Again, the number of people who retire and take available subsidies can only be estimated and thus that liability cannot be immunized.

Bond proponents answer by saying that in a large pool, mortality and retirement assumptions can be predicted with reasonable accuracy. This answer contains two gaping holes. First, it is not applicable to small- and mid-sized plans where there is not a large pool. Second, retirement assumptions are made based on reasonable predictions regarding a business' future prospects. Obviously, these assumptions do not anticipate the retirement of substantially all early retirement eligible employees. To do so would be both unrealistic and enormously expensive.

However, when the sponsoring company's business deteriorates, there may well be layoffs and possibly widespread use of the subsidy by substantially all early retirement eligible employees. In those circumstances, the plan will, *by definition*, be substantially underfunded. And, with the company having difficulties, it is at exactly this time that the plan may well be turned over to the PBGC with significant unfunded liabilities.

In other words, "immunization" is theoretically viable until a company encounters difficulties, at which time it will *inevitably* become underfunded.

Thus, the end result of "immunization" is:

(1) a lower rate of plan earnings and correspondingly higher company costs,

(2) resulting lower benefits, and

(3) a system that systematically ensures large PBGC liabilities whenever a company's fortunes decline.

This is not an answer but a formula for disaster for participants and for the PBGC.

The higher long-term rate of return available with equities is what makes plans affordable for companies. These rates of return also are the most effective means for all affected parties to weather a downturn in the business of the sponsoring employer. Investing in equities involves some short-term volatility but is critical to the successful functioning of the defined benefit plan system for companies, participants, and the PBGC. Thus, it is critical that the law not establish rules that adversely affect plans investing in equities.

Preventing Volatility by Smoothing the Transition Between the ERISA Funding Rules and the DRC

Overview

Under present law, generally, there are two distinct funding regimes. All plans are subject to the "ERISA funding rules." In addition, plans that fall below certain funding levels are required to make deficit reduction contributions (DRCs) to the extent such contributions exceed the amount required under the ERISA funding rules.

The DRC and ERISA funding rules serve distinct purposes and, in general, should both be preserved. The ERISA funding rules reflect the long-term nature of the pension promise by incorporating future projections. With respect to this aspect of the funding rules, current law provides appropriate flexibility to apply assumptions based on reasonable plan-specific projections regarding, for example, plan rates of return and mortality.

definition

Deficit Reduction Contribution (DRC)
An amount in addition to the required minimum annual contribution if the pension plan is less than 100 percent funded. It consists of old liabilities (such as benefit increases granted before 1988), which are to be amortized over 18 years, and a share of new liabilities (resulting from benefit increases or plan amendments)

— Source: International Foundation on Employee Benefits, Employee Benefits: A Glossary of Terms

The DRC rules were designed to function as a backstop to the ERISA funding rules. The DRC rules ensure that on a snapshot basis, the plan does not become too underfunded. Because of the backstop nature of the DRC rules, plans are restricted with respect to their discount rate and mortality assumptions. In other words, it may make

sense to prohibit the use of plan-appropriate assumptions under the DRC so as to create a mechanically applied backstop. But such a prohibition would not make sense under the ERISA funding rules, which serve a different purpose based on each plan's circumstances and accordingly are structured to apply in a more plan-specific manner.

Although we believe that the basic structure of the DRC and ERISA funding rules should be preserved, we believe that the rules should be reformed in certain important respects.

ERISA funding rules

In certain aspects, the ERISA funding rules permit funding to be made over too long a period. Specifically, the ERISA funding rules permit the cost of a plan amendment to be amortized over 30 years. Yet amendments typically have the greatest effect on employees who have had significant service with the employer already and accordingly tend to be older. A more appropriate amortization period would be related to such employees' expected future service with the employer. One approach would be to determine the amortization period using a methodology based specifically on such expected future service. However, a comparable result can be achieved much more simply by reducing the amortization period for plan amendments to a shorter period representative of typical workforces, such as 15 years.

DRC rules tend to put far too much pressure on businesses in cyclical industries or other companies experiencing a temporary downturn.

Deficit Reduction Contribution (DRC)

The DRC requirements generally only apply to plans that are less than 90 percent funded on a current liability basis. However, a plan that is less than 90 percent funded is exempt from the DRC requirements if (a) the plan is at least 80 percent funded, and (b) for two consecutive years (out of the preceding three years), the plans was at least 90 percent funded (the "90 percent/80 percent rule").

Under the main component of the DRC regime, an employer subject to the regime generally must contribute a specified percentage of its unfunded liability. The percentage varies from 30 percent for the worst funded plans (plans at 60 percent or less) to just over 18 percent (for plans just below the 90 percent level).

At the same time that the ERISA funding rules are made more demanding by shortening the amortization period for plan amendments, the DRC rules should permit more funding flexibility. This is important for two reasons. First, employers experience jarring volatility when they first move from the ERISA funding rules to

the DRC regime. The sudden increase in funding attributable to the application of the DRC rules can be difficult to foresee and can be very disruptive for an employer attempting to revitalize its business. Accordingly, it is important to smooth out the transition from the ERISA funding rules to the DRC regime by making the ERISA funding rules more demanding (as described above) and by permitting more flexibility under the DRC rules.

Second, the DRC rules tend to put far too much pressure on businesses in cyclical industries or other companies experiencing a temporary downturn. Requirements to fund up to 30 percent of a plan's funding shortfall in one year may simply be unmanageable for such companies. On the other hand, it is very important that the funding status of underfunded plans improve. Weighing these two competing considerations, the Council makes the following recommendations.

The Council recommends stricter rules with respect to the benefits provided by underfunded plans.

The DRC requirements should not be so severe as to hinder the recovery of the company and thus the plan. Accordingly, the percentage of the funding shortfall that must be contributed should be reduced so that it ranges from 20 percent (for plans funded at 60 percent or less) to just above 8 percent (for plans just below 90 percent funded) (instead of the current-law range of 30 percent to just over 18 percent). The 20 percent figure corresponds in an approximate manner to the five-year amortization of experience gains and losses under the ERISA funding rules, which is the shortest amortization period applicable under those rules.

At the same time, we recommend that the universe of plans to which the DRC rules apply be expanded. Specifically, we recommend reexamining the 80 percent component of the 90 percent/80 percent rule (except for purposes of related disclosure rules). And, as discussed in the next section of this paper, the Council recommends stricter rules with respect to the benefits provided by underfunded plans.

It is important that the 90 percent/80 percent rule not be replaced with a 100 percent rule subjecting all plans below 100 percent funded to the DRC rules. A 100 percent rule would unreasonably discourage new plans and benefit increases, as well as unduly "punish" normal fluctuations of interest rates and asset values. Such a rule would also materially increase the number of plans subject to the volatile movement between the ERISA funding rules and the DRC regime.

Finally, it is important to focus on the purpose of the DRC rules. The DRC regime is a backstop to the ERISA funding rules and, as such, is based on

an artificial snapshot measurement of the funded status of an ongoing plan; it would not be appropriate to turn this artificial measurement into an overly restrictive rule that controls the funding of most plans, the vast majority of which are not terminating.

Restrictions on Underfunded Plans

The Council has significant concerns regarding benefit increases in underfunded plans. If a plan is significantly underfunded, that is the time to improve its funded status, not to exacerbate the underfunding.

Under present law, an employer must provide security to a plan to the extent that a plan amendment causes the plan's funded level to fall below (or further below) 60 percent. The 60 percent figure should be raised to 75 percent (instead of 80 percent, as proposed by the Administration).

Also, underfunded plans that permit lump-sum distributions can spiral downward very quickly. In some circumstances, there can be a "rush to retire" by employees who fear that the last participants in the plan will not receive their full benefit.

Even if there is not such a rush, lump-sum distributions can drain a plan of assets at a low point in the market and deprive the plan of a realistic chance to recover. Accordingly, under a possible proposal, lump-sum distributions would be suspended for plans that fall below 75 percent funded. However, the Council remains very concerned that a forthcoming freeze could trigger an even greater move to retire and thus have a counterproductive effect on the plan. This possibility should be carefully evaluated before moving forward on this proposal (or on the Administration's *similar* proposal).

Permitting and Encouraging Additional Contributions in Good Times

The lesson of the last 10 years is that companies need to be permitted and encouraged to make additional contributions in "good economic times" so that plans have a funding cushion to rely on during "bad economic times." Trying to squeeze huge contributions from companies during a downturn in the economy will only lead to freezes on benefits, company bankruptcies, and large liabilities shifted to the PBGC. The time to build up pension assets is during good economic times, not bad times.

In this regard, the Council strongly recommends the following.

Increase in the deduction limit
The Finance Committee pension bill (the National Employee Savings and Trust Equity Guarantee (NESTEG) Act of 2004, S. 2424 in the 108th Congress) provided that an employer may always

deduct the excess of 130 percent of current liability over the value of plan assets. This proposal increases the deduction limits currently in Code section 404(a)(1)(D) from 100 percent of current liability to 130 percent. The Administration includes this provision in its proposal as well.

We strongly support this proposal. In fact, we would recommend increasing the 130 percent figure to 150 percent based on the following analysis. For deduction purposes, current liability is today based on the 30-year Treasury bond rate, not the long-term corporate bond rate.

The time to build up pension assets is during good economic times.

Under our proposal, current liability would in the future be based on the long-term corporate bond rate for all purposes. This would, in isolation, actually decrease the deduction limit for many plans by 10 percent or 15 percent (and by more for a few plans). Accordingly, to ensure that the deduction limit for most plans is increased by 30 percent compared to current law, the limit should be increased to approximately 150 percent.[2]

It would be appropriate for both policy and revenue reasons to limit the increase in the deduction limit to plans insured by the PBGC.

Repeal of the excise tax on nondeductible contributions

Under current law, an excise tax is imposed on employers that make certain nondeductible contributions. This tax was enacted when the tax on reversions was much lower. With a very high excise tax on reversions, there is no reason to be concerned about excessive funding of defined benefit plans. On the contrary, the excise tax on nondeductible contributions can only discourage employers from desirable advance funding. Accordingly, the excise tax on nondeductible contributions should be repealed with respect to defined benefit plans.

Repeal of the combined plan deduction limit on employers that maintain both a defined benefit plan and a defined contribution plan

Under present law, if an employer maintains both a defined contribution plan and a defined benefit plan, there is a deduction limit on the employer's combined contributions to the two plans. Very generally, that limit is the greatest of:

(1) 25 percent of the participant's compensation;

(2) the minimum contribution required with respect to the defined benefit plan; or

[2] This increase will, *inter alia*, allow employers to fund collectively bargained benefit increases more quickly than under current law.

(3) the unfunded current liability of the defined benefit plan.

This deduction limit can cause very significant problems for an employer that would like to make a large contribution to its defined benefit plan. And there is no policy reason for preventing an employer from soundly funding its plan.

Repeal of the combined plan deduction limit is the simplest, most direct solution to the problems created by the present law limit.

Accordingly, the Council recommends that the combined plan deduction limit be repealed for any employer that maintains a defined benefit plan insured by the PBGC. Defined benefit plans and defined contribution plans are each subject to appropriate deduction limits based on the particular nature of each type of plan. There is no policy rationale for an additional separate limit on combined contributions.

In many ways, repeal of the combined plan deduction limit is a conforming change to the repeal in 1996 of the combined plan benefit limit, which limited the combined benefit that an individual participant could receive from a defined benefit plan and a defined contribution plan.

We believe that repeal of the combined plan deduction limit is the simplest, most direct solution to the problems created by the present law limit. However, in general, other proposals would also effectively address the problems being encountered.

Specifically, the current combined plan deduction limit could be modified to disregard employer contributions to defined contribution plans up to 6 percent of the participants' aggregate compensation. (See Section 204 of The Pension Presentation and Savings Expansion Act of 2003, H.R. 1776 as passed by House Ways and Means Committee in the 108th Congress and Section 407 of S. 2424 (as passed by the Senate Finance Committee in the 108th Congress.)) In addition, the current-law reference to unfunded current liability should be conformed to the change recommended above, so that contributions to a plan insured by the PBGC would always be deductible to the extent necessary to increase the plan's funded level to 150 percent.

We are supportive of the proposals passed by the Ways and Means Committee and the Finance Committee in 2004. But, as noted, we recommend repeal of the combined plan deduction limit. We do not believe that the additional complexity of the narrower proposals is necessary. Those proposals would create significant issues for multiemployer plans; since multiemployer plan benefits are not based on participants' compensation, deduction rules based on percentages of participants' compensation can be difficult to apply.

Preservation of credit balances

Under current law, an employer maintaining a defined benefit plan is generally required to make certain minimum contributions to the plan. An employer may, however, choose to contribute amounts in excess of the minimum required. Such "extra" contributions give rise to a "credit balance," *i.e.*, a type of bookkeeping record of the excess contributions made by an employer.

Present law neither encourages nor discourages "extra" contributions. Instead, in years after a credit balance is created, an employer's minimum funding obligation is determined as if the amount of any credit balance were not in the plan. Then, the credit balance is applied against the minimum funding obligation determined in this manner.

In this way, the law is carefully crafted to be neutral with respect to a company's decision whether to make extra contributions. The law is structured to treat a company that makes an extra contribution in one year and uses the resulting credit balance in a subsequent year in the same manner as a company that only makes the minimum contribution in all years.

If credit balances were not available to satisfy future funding obligations, employers would have a clear economic disincentive to fund above the minimum levels; funding above the minimum levels would, in the short term, decrease funding flexibility and increase cumulative funding burdens. If an employer does not receive credit for extra contributions, the employer would have an incentive to defer making contributions until they become required.

The credit balance system has been criticized on the following grounds: Critics have pointed to examples of underfunded plans that have not been required to make contributions because of credit balances. Some of those plans have had their liabilities transferred to the PBGC.

> "Current pension funding rules ... severely limit the ability of companies to fund their plans during good economic times, while requiring additional contributions during difficult economic times."
>
> —*from the Council's* Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System

One possible reaction to this criticism would be to prohibit the use of credit balances in the case of underfunded plans, as the Administration has proposed. At first blush, this type of proposal would seem to increase funding. In fact, the opposite is true. Such a proposal would lead to more underfunding and more PBGC liability. If contributions above the minimum amount are discouraged, few if any companies will make extra contributions. That can only lead to more underfunding.

For example, if the use of credit balances were restricted, the companies cited by the critics would likely not have made extra contributions and accordingly, even greater liabilities would have been shifted to the PBGC and the PBGC would have assumed these liabilities sooner.

The other criticism of credit balances is that they are not adjusted for market performance. For example, assume that a company makes an extra $10 million contribution. Assume further that the plan experiences a 20 percent loss with respect to the value of its assets during the following year. Under current law, the $10 million credit balance grows with the plan's assumed rate of return (*e.g.*, 8 percent) until it is used. So after a year, the credit balance would be $10.8 million. The critics argue that the credit balance should actually be $8 million in this example, to reflect the plan's 20 percent loss.

This concern regarding market adjustments is a valid concern that should be addressed legislatively on a prospective basis and should apply to increases and decreases in market value.

As noted above, employers need to be encouraged to make extra contributions in "good times" so that they will have a sufficient cushion for the "bad times." If the use of credit balances is restricted, companies would not make extra contributions except in unusual circumstances. It goes without saying that that would be a major step backward. If we want companies to fund more in good times, it is essential that we preserve the credit balance system.

Credit balance terminology

One cosmetic issue could actually help put the credit balance discussion into perspective. The term "credit balance" does not appropriately capture the clear policy justification for the structure of the rules. It may be more appropriate to refer to a credit balance as a "pre-payment account." That would highlight the inconsistency of the credit balance critics' two positions:

(1) they seek to deny companies the ability to use their funding pre-payments; and

(2) at the same time, they express a desire to encourage companies to make such pre-payments.

Credit balances under the DRC

As discussed above, present law is structured to be neutral with respect to a company's decision whether to make contributions above the minimum required amount. From a policy perspective, we believe that companies should actually be encouraged to make such additional contributions. On the other hand, we need to be careful not to create incentives that can permit underfunding in later years.

With this delicate balance in mind, we recommend that for purposes of determining the percentage of the funding

shortfall that must be funded under the DRC rules, credit balances not be subtracted from plan assets.

Assume, for example, that a plan with $75 million of assets is 75 percent funded and has a $5 million credit balance. Under present law, the DRC would apply as follows. The funding shortfall would be determined by subtracting the $5 million credit balance from the $75 million in assets. Thus, the funding shortfall would be treated as $30 million, not $25 million. The percentage of that shortfall that must be contributed would be determined on the same basis, *i.e.* as though the plan had only $70 million. Thus, the percentage would be 26 percent (rather than 24 percent, which would have applied if the plan were treated as having $75 million of assets).

In short, under present law, the DRC required contribution would be 26 percent of $30 million, *i.e.*, $7.8 million. The company could offset its credit balance against that amount and would be required to contribute the remaining $2.8 million.

We recommend a modification of this structure to provide a small incentive for companies to pre-fund. Under our proposal, the percentage of the funding shortfall that would be contributed would be based on the plan's actual assets, *i.e.*, $75 million rather than $70 million in the above example. The funding shortfall would not be affected; it would be treated as $30 million, as under present law. In the example, this would mean that the DRC required contribution would be 24 percent (as opposed to 26 percent) of $30 million, *i.e.*, $7.2 million (as opposed to $7.8 million). As discussed above, the company would be required to contribute the excess of this amount over its credit balance, *i.e.*, $2.2 million.

The credit balance system has been criticized on the grounds that some underfunded plans have not been required to make contributions.

Our proposal would tilt the rules slightly to favor pre-funding without disturbing the fundamental purpose of the DRC rules. In fact, by basing the DRC percentage on actual plan assets, the proposal would actually make the rules more solidly grounded in the actual funded status of the plan.

PBGC premiums

The Administration has proposed dramatic increases in PBGC premiums in order to address the PBGC deficit. This proposal gives us great concern for several reasons.

First, the large proposed increase in the flat-dollar premium and its indexing is strikingly inappropriate. This is a very large increase on the employers that have maintained a well-funded plan through the "perfect storm" of lower interest rates and a downturn in the

equity markets. It is wrong to "reward" these employers with the obligation to pay someone else's debt.

Second, the unspecified increase in the variable rate premium will become a source of great volatility and burden for companies struggling to recover. This could well cause widespread freezing of plans by companies that would otherwise recover and maintain ongoing plans.

> "The substantial assets the PBGC holds — and the relatively modest size of its deficit when viewed in the context of the economic cycle and its capped and long-term liabilities — ensure that the PBGC will remain solvent far into the future — a point the PBGC itself has acknowledged repeatedly."
>
> —*from the Council's* Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System

Third, a premium increase misses the point of the last 10 years. The solutions to underfunding is better funding rules, not higher premiums that, on a dollar for dollar basis, hurt the defined benefit plan system.

Fourth, there has been a striking lack of clarity about the real nature of the PBGC deficit. The PBGC's numbers are based on a below-market interest rate. Our questions are:

(1) with a market-based interest rate, what would the deficit be?

(2) What effect would a small increase in interest rates and the equity markets do to address the PBGC deficit? and,

(3) Why has PBGC unilaterally moved away from equities to lower-earning investments that hinder its ability to reduce its deficit?

These are troubling questions that should be addressed before the very harmful step of increasing PBGC premiums is taken.

Shutdown Benefits (or Other Unpredictable Contingent Event Benefits)

Shutdown benefits generally occur in collectively bargained plans and are a form of "unpredictable contingent event benefits." They are analogous to a severance benefit; they generally "spring into existence" if and only if a unit, division, or workplace is closed and workers are laid off. A company cannot effectively pre-fund shutdown benefits for two reasons. First, there are clear difficulties and problems with a healthy company making funding judgments based on its determination of the likelihood that a unit will be shut down in the future. Second, even if such a likelihood could be determined, the plan would still be woefully underfunded if there is actually a shutdown since the likelihood would presumably have been fixed far below 100 percent (at least until shortly before the shutdown).

Thus, it is difficult to pre-fund shutdown benefits. On the other hand, shutdown benefits are guaranteed by the PBGC, subject to the generally applicable five-year phase-in. This phase-in appears to commence when the plan document first provides for shutdown benefits, not when the shutdown occurs. Thus, if the shutdown occurs when the employer is declaring bankruptcy, the PBGC can become liable for shutdown liabilities that have not been funded.

Shutdown benefits, a form of 'unpredictable contingent event benefits,' are clearly a problem area.

Shutdown benefits are clearly a problem area. Some have suggested that the law be changed so that the phase-in of the PBGC guarantee of shutdown benefits begins when the shutdown occurs. With respect to shutdown benefits that have not yet been bargained for and included in a plan document, that might be the right answer. But it seems unfair to apply this rule to benefits already contained in plans.

The Council recommends consideration of alternative solutions. For example, currently the variable rate premium payable to the PBGC by underfunded plans is determined without regard to shutdown benefits (where the shutdown has not occurred). Thus, PBGC is not even collecting premiums on these insured benefits.

One alternative that could be considered is requiring shutdown benefits (and other unpredictable contingent event benefits) to be taken into account at full value (or at a percentage of full value) for purposes of determining the variable-rate premium payable to the PBGC. Before moving forward on such a proposal, it would be critical to assess possible repercussions (such as benefit freezes to avoid variable rate premiums).

Lump-Sum Distributions

The discount rate used to determine the amount of a lump-sum distribution should be conformed to the funding discount rate (which, as discussed above, should be the long-term corporate bond rate).

Under current law, a rate no higher than the 30-year Treasury rate must be used to determine the lump-sum distributions payable to participants in defined benefit plans that offer lump sums. As the 30-year Treasury rate has become artificially low, it has had the corresponding effect of artificially inflating lump-sum distributions (*i.e.*, the lump sum projected forward using a reasonable rate of return is more valuable than annuity on which it was based). This has had very unfortunate consequences. First, these artificially large sums are draining plans of their

assets. For example, if a plan determines its funding obligations based on the long-term corporate bond rate, but pays benefits based on a much lower rate (such as the 30-year Treasury rate), the plan will be systematically underfunded. For the defined benefit plans that offer lump sums (roughly half the plans), the centerpiece of funding reform — the replacement of the 30-year Treasury bond rate — will simply be illusory unless the lump-sum discount rate is conformed to the funding rate.

definition

Lump-Sum Distribution
A distribution that qualifies for forward averaging or rollover treatment. The basic requirements are that the distribution be made within one taxable year of the recipient, that it include the entire balance to the credit of the employee, and that it be made on account of the employee's death, attainment of age 59½, separation from service (except for the self-employed), or disability (self-employed persons only).

— *Source: International Foundation on Employee Benefits,* Employee Benefits: A Glossary of Terms

Second, participants have clear economic incentives to take lump-sum distributions, instead of annuities. The discount rate should not artificially create an uneven economic playing field that discourages annuities.

We recognize that the artificially large lump sums of recent years have built up employee expectations. For employees near retirement (*e.g.*, within 10 years of normal retirement age) who have made near-term plans based on present law, transition relief is clearly appropriate. But in the strongest terms, we urge policymakers not to go further than that. If over the next 10 to 15 years, plans are required to give inflated distributions to retirees, that can only hurt the defined benefit plan system and future participants. In the competitive world we live in, pensions are *at best* a zero-sum arrangement. If employers have to pay inflated benefits for 10 or 15 years, they will have to recoup that cost in some way. It is our fear that many will feel compelled to reduce benefits for the next generation, a reduction that will likely carry forward to all future generations.

The Administration's proposal to apply the yield curve to determine lump sums would

(1) appear to further increase the value of lump sums and thus exacerbate the current law problems described above;

(2) increase benefits for higher paid employees who can afford to let their benefits remain in the plan longer; and

(3) force a significant reduction in cash balance plan benefits.

We cannot support this proposal.

Defined Benefit Plan Valuation Date

Prior year rule
The Administration's proposal would repeal the rule enacted in 2001 permitting well-funded plans to use a

valuation date in the preceding plan year. This prior-year rule was carefully limited so as not to unintentionally encourage underfunding. Repealing it is, accordingly, unjustified and would hurt those well-funded plans that have relied on this rule to make business planning more efficient.

Asset valuation

Under present law, a defined benefit plan's assets and liabilities must be valued as of the same date. Subject to certain exceptions (such as the prior year rule discussed above), that date must be within the plan year for which the valuation is being performed. This valuation is performed for purposes of determining the funding requirements and deduction limits with respect to the plan.

For large defined benefit plans, it is generally impractical to have a valuation date other than the first day of the plan year.

For large defined benefit plans, it is generally impractical to have a valuation date other than the first day of the plan year. Because records are kept on a plan year basis, the only other potentially practical alternative generally is the last day of the plan year. The last day, however, is impractical because valuing a plan's liabilities is an extensive process. If that process were to begin on the last day of the plan year, an employer would be unable to complete the valuation in time to satisfy certain funding requirements. The one item used in the valuation that is readily obtainable on the last day of the plan year is the value of the assets.

In a falling market, using the first day of the plan year as the valuation date inordinately delays the recognition of asset losses occurring during a plan year. For example, assume that assets are valued at $100 million on the first day of the plan year but have fallen to $80 million on the last day of the plan year. For funding purposes, the employer must treat the plan as if it had, as of the last day of the plan year, $100 million plus the assumed rate of return for the year, for a total of, for example, $108 million. With $108 million in the plan, there may, for instance, be little or no funding obligation; in fact, any amount contributed may be nondeductible. This could leave the employer in the odd position of being unable to fund the plan while knowing that the plan has $28 million less funding than the valuation implies. The $28 million shortfall will eventually trigger an additional funding obligation in later years.

We recommend that an employer be permitted to elect to value assets as of a later date than it values liabilities, but no later than the end of the plan year for which the valuation is being performed. (See sections 704(a)(2) and 704(b)(2) of the Pension Preservation

and Savings Expansion Act (H.R. 1776, as introduced in the 108th Congress). This is appropriate because updated asset values are much more readily available than new liability figures.

As a practical matter, for an employer that uses this new rule, the proposal will generally mean that liabilities will be valued as of the first day of the plan year and assets will be valued as of the last day of the plan year. In the falling market example described above, use of this new rule would enable — and in many cases compel — the employer to make additional contributions to the plan. This will allow — or compel — a better matching of the need for increased funding with the requirement to fund.

The Council's recommended proposal would not undermine funding in rising markets and would significantly improve funding in falling markets.

In a rising market, the proposal would not undermine funding. Briefly stated, the increased asset value that can be taken into account under the proposal never decreases a funding obligation on a greater than dollar-for-dollar basis, thus resulting in no overall asset shortfall.

Moreover, the proposal is not subject to abuse or manipulation. First, a plan's valuation date is part of the funding method, which can only be changed with IRS approval. Thus, an employer cannot switch in and out of this new rule in order to use it only when it meets the plan sponsor's current wishes. Second, in order to compare "apples to apples," plan liabilities would be projected forward actuarially to the last day of the year (*i.e.*, the date as of which assets are valued).

In short, this proposal would not undermine funding in rising markets but would significantly improve funding in falling markets. In addition, the proposal has safeguards to ensure that it cannot be manipulated to avoid funding obligations.

Reform of Funding Waiver Rules

Generally, under present law, employers are technically able to obtain a short-term waiver of the funding requirements upon a showing of temporary substantial business hardship. These rules were intended to provide a safety valve to accommodate downturns in the business cycle.

In practice, the rules have not worked well. There are no clear standards for obtaining a waiver and the application process is long, difficult, and unpredictable. The rules governing funding waivers should be made more mechanical and less dependent on IRS discretion. For example, a waiver should be available where, in the absence of plan

amendments or similar events, there is an excessive increase in funding requirements from one year to the next.

In certain circumstances, an employer may need a waiver of only a portion of its funding obligation. Current law does not technically permit partial waivers, though informally the IRS has on occasion permitted partial waivers in an indirect manner. We recommend formally allowing partial waivers. It is important to formalize the partial waiver system so that partial waivers do not count as a full waiver for purposes of the rule limiting waivers to no more than three of any 15 consecutive plan years (five of 15 in the case of a multiemployer plan).

Interaction with Potential Accounting Rule Changes

The accounting issue is discussed at greater length in *Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System* (May 2004) prepared by the Council. That document discusses the possibility that the accounting rules will be changed to require that pension assets be marked to market.

Enhanced disclosure regarding the financial repercussions of pension sponsorship is appropriate to ensure shareholders have the information they need. However, because of the adverse effect mark-to-market accounting would have on defined benefit plan sponsorship, accounting standard setters should be extremely cautious when evaluating this approach and should recognize that adoption of a mark-to-market standard could lead to a reduction in the pension promises made by employers to better insulate themselves from the volatility injected into pension funding, or possibly a wholesale abandonment of defined benefit plans.

Mortality Assumptions

The Treasury Department has begun the process of evaluating issues related to mortality assumptions used with respect to defined benefit plans. The Council looks forward to a meaningful dialogue with Treasury as the administrative process moves forward.

Rules Based on an Employer's Creditworthiness

Under the Administration's proposal, the application of pension funding and premium rules would turn on the creditworthiness of the employer sponsoring the plan. Very briefly, the Council is strongly opposed to this proposal and the dramatic expansion of government regulation that underlies this proposal.

Use of credit ratings to determine funding or PBGC premium obligations

would be harmful to plans, companies, participants, and the PBGC. Such use would put severe additional pressures on companies experiencing a downturn in their business cycle. Those pressures will undermine companies' ability to recover which adversely affects all parties, including the PBGC.

Use of credit ratings to determine funding or PBGC premiums would be harmful to plans, companies, participants and the PBGC.

This proposal would clearly lead to some level of government oversight of the credit rating entities and to some form of government approval of such ratings. This would be a frightening precedent. In addition, having PBGC premium levels or funding rules turn on an employer's creditworthiness would also exacerbate the downward spiral currently experienced by companies that are downgraded. Finally, there is no practicable way to apply a creditworthiness test to non-public companies.

Surplus Assets

We fully recognize the political sensitivities involved in the issue of employers' access to surplus assets in their defined benefit plans. And because of that sensitivity, we do not put forward any specific proposal on this topic. However, we urge Republican and Democrats together to reexamine this issue in a bipartisan manner.

It seems inevitable that new funding rules will require significant new defined benefit plan contributions. If the equity markets recover, these new contributions could well result in large surpluses that are virtually unusable. The fear of creating unusable capital will clearly discourage many employers from maintaining defined benefit plans.

On the other hand, if our objective is to encourage both sound funding and defined benefit plan sponsorship, few proposals would be more effective than proposals allowing employers tax-free access to surplus assets to pay for other benefits.

Restructuring for Troubled Plans

In certain circumstances, a combination of economic forces — such as competitive changes within an industry, the aging of a company's workforce, falling interest rates, and a downturn in the equity markets — can result in a dramatic change in the viability of a company's defined benefit plan. In those cases, following the otherwise applicable rules can only lead to plan termination and severe economic troubles for the company sponsoring the plan. It is critical that we develop a

different solution for these troubled plans.

The Council recommends that alternative approaches be developed that would address this situation in a way that does not increase PBGC exposure, but rather is structured to reduce that exposure. In this regard, proposals should be developed that generally permit a company in this situation to cease benefit accruals (or pay for any new accruals currently) and to fund the funding shortfall over a longer period of time. This benefit-freeze approach can help revitalize the company, increase the funding level of the plan, avoid termination of the plan, and correspondingly avoid shifting liabilities to the PBGC.

Multiemployer Plans

Multiemployer plans serve a unique and critical role in the private pension system. As the population of employers participating in these plans changes, new challenges arise for the plans and participating employers. This is especially true in the case of plans where employer departures have thinned the number of participating employers considerably.

The Council looks forward to working with the multiemployer plan community to address the critical issues facing these plans.

Transition Rules and Phase-ins

As pension funding reform moves forward, transition issues need to be carefully studied. Large additional funding burdens that are suddenly imposed can disrupt business plans and cause otherwise viable companies to become insolvent. Such insolvencies would only increase burdens on the PBGC.

Fairness also dictates that the rules be phased in slowly for participants, unions, and companies that have structured their arrangements based on present-law rules.

> "Concerns about the volatility of the funding liability have complicated the task of preserving [defined benefit] plans and pose a challenge for designing new plans that will be attractive to employers."
>
> —*from the Council's* Safe and Sound: A Ten Year Plan for Promoting Personal Financial Security

STATEMENT FOR THE RECORD OF RICHARD L. TRUMKA
SECRETARY-TREASURER
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS
815 Sixteenth Street, NW
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To the
COMMITTEE ON FINANCE
UNITED STATES SENATE
March 1, 2005

The AFL-CIO strongly opposes the Bush Administration's recent proposal to restructure the funding rules and change the federal insurance program for single employer defined benefit pension plans. Taken as a whole, this proposal will do far more harm than good to the defined benefit pension system, weakening retirement security for American workers and retirees.

While purporting to be in the best interests of pension plan participants and beneficiaries, the proposal primarily serves the institutional interests of the Pension Benefit Guaranty Corporation (PBGC) at the expense of participants and beneficiaries. The proposal gives employers new reasons to reevaluate their sponsorship of defined benefit plans, threatening the stability of the defined benefit pension plan system overall.

The proposed changes will increase needlessly the volatility and complexity of the pension funding rules for all single employer plans. The administration's approach would force sponsors to determine a plan's funding status and required contribution amounts based on sudden swings in interest rates and asset values. As a result, employers could face large and unpredictable increases in required contributions during economic downturns, when they are least able to make contributions. Furthermore, requiring use of a ''yield curve'' to measure pension liabilities will only exacerbate the crisis in our manufacturing sector because of its disproportionate impact on employers with a higher share of older workers.

Equally troubling is the administration's plan to penalize companies when they already are facing financial difficulties. The sharply higher premiums to be paid to the PBGC by companies with underfunded plans—an additional $12 billion over the next five years alone—jeopardize the entire defined benefit pension system by diverting critical dollars that could be used to fund pensions at financially weak companies.

The administration's overall focus on higher premiums is misguided. It fails to address or even acknowledge the root causes of the PBGC actuarial deficit—the collapse of pension plans and companies throughout the steel industry and the ongoing restructuring within the airline industry. And for workers whose plans are now in jeopardy, the administration offers no plan to save and secure their pension benefits.

The administration also penalizes workers by cutting federal pension guarantees, outlawing benefits that protect workers in the event of a plant shutdown, and restricting the benefits workers earn at companies with financial difficulties. And where workers have formed a union to bargain with their employers, the proposal would interfere with existing collective bargaining agreements.

In sum, the Bush Administration proposal for pension ''reform'' likely will do more to prompt employers' exit from the defined benefit pension plan system than to shore up workers' retirement security. A strong and vibrant defined benefit pension system is crucial to building real retirement security for working families on top of Social Security and personal savings. It is important that Congress get the details of pension reform right; otherwise, irreparable harm may be done to an already fragile pension system. We look forward to working with you to ensure a secure retirement for America's workers, and thank you for your consideration of our views.

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Comments Presented to the Committee on Finance
United States Senate

Hearing on
The Financial Status of PBGC and the Administration's Defined Benefit Plan Funding Proposal

March 1, 2005

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Finance Committee on several important elements of defined benefit reform. ASPPA is a national organization of almost 5,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, and attorneys. Our large and broad based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

ASPPA applauds the Committee's leadership in exploring defined benefit funding reform. The Senate Finance Committee's consistent focus on pension issues over the years has advanced improvements in the employer-sponsored pension system, as well as led to an increased awareness of the need to focus attention on the retirement security of our nation's workers. ASPPA looks forward to working with Congress and the Administration on strengthening the defined benefit system.

Maximum Deductible Contribution Limit

The Administration has stated that their defined benefit reform proposal is intended to strengthen workers' retirement security by ensuring that defined benefit plans are adequately funded. To this end, they have proposed a maximum deduction amount using a combination of a plan's new ongoing liability funding target and a 30 percent cushion of such new funding target. ASPPA believes that this new maximum deduction limit does not adequately address the needs of small to medium-sized companies.

For a healthy plan sponsor, the Administration's new maximum deductible contribution would be equal to the present value of all accrued benefits, (assuming a salary increase factor

and computed using the proposed yield curve), plus a 30 percent cushion of this amount. The Administration has stated that their suggested reforms to the current defined benefit funding rules, including the maximum deduction rules, ensure adequate funding and would provide greater flexibility for employers to make additional contributions in good economic times.

After close analysis of the Administration's proposed maximum deductible contribution limit, in conjunction with the allowable actuarial assumptions for such a calculation, ASPPA has discovered that in certain circumstances involving small to medium-sized companies, the Administration's proposed maximum deductible contribution limit would actually be *decreased,* rather than *increased,* as compared to current law. This would preclude small to medium- sized employers from funding their plans sufficiently as they can under current law. Thus, rather than strengthening the funding rules, the proposed reform would, in some cases, actually weaken them.

Consider the following example: A defined benefit plan has been established with 21 participants (6 highly-compensated and 15 non-highly compensated), with a defined benefit formula based on 4 percent of average pay for each year of participation up to a maximum of 25 years. Under current law, and based on allowable actuarial assumptions, the maximum deductible contribution that could be made to this defined benefit plan would be $382,914. The maximum deductible contribution allowable under the Administration's formula, based on a yield curve and allowable actuarial assumptions, would be $273,048. This amounts to a funding difference of $109,866, which is certainly significant for a small business. Although this funding difference occurs when a plan is first established, it is important to keep in mind that this funding deficiency will have to be made up later, when the small business may not be in a financially-sound position to do so.

The reason for this discrepancy in the maximum deductible contribution is based on the fact that the Administration's proposal, although allowing for an assumption for salary increases for workers, does not allow the plan to assume salary increases for many small business owners. This is because the Administration's proposal does not permit the plan to assume the statutorily provided inflation increases in the compensation limit for determining benefits [IRC section 401(a)(17)].[1] As a consequence, some plans will not be able to fund for these small business owner benefits, even though the law allows such benefits to be accrued. The resulting funding mismatch is a particular problem for successful small businesses. While some plans would be able to take advantage of the 30 percent cushion provided under the Administration's proposal, many others, such as the small business in this example, would not.

For many small and medium-sized companies, not being allowed to assume the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit will create an inappropriate funding deficiency when a plan is first established. Thus, since the Administration's current proposal effectively discriminates against the benefits of many small business owners, the plan will potentially have a funding shortfall just as it starts. Significantly, under the above example, if the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit were allowed to be assumed, the maximum

[1] The annual compensation limit under the "401(a)(17)" limit cannot generally exceed $200,000, to be adjusted for cost-of-living increases beginning in 2002. The current 401(a)(17) limit for 2005 is $210,000.

deductible contribution limit under the Administration's proposal would increase to $363,313, a contribution limit similar to current law.

Based upon these results, **ASPPA recommends** that the Administration funding proposal be modified to permit the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit to be assumed for purposes of calculating the maximum deductible contribution limit in order to assure funding adequacy for all plans, including small businesses. As we have shown, the Administration's proposal would unfairly discriminate against successful small businesses and hinder the creation of new defined benefit plans. Concurrently, ASPPA supports an increase in the deduction limit of a plan's ongoing liability funding target from the proposed 130 percent to 150 percent of such target. By increasing this cushion, employers would be provided with more flexibility in determining their pension contributions, particularly in good economic times. Being able to make additional pension contributions in good times would also be consistent with the Administration's proposal that defined benefit plans be adequately funded.

Disclosure under Schedule B of the Form 5500

A main concern of the Administration is that the asset and liability information provided under the current Schedule B of the Form 5500 annual report/return does not adequately provide an accurate and meaningful measure of a plan's funding status. Under the Administration's proposal, all single-employer defined benefit plans covered under the Pension Benefit Guaranty Corporation (PBGC) with more than 100 participants, and required to make quarterly contributions for the plan year, would be required to file a Schedule B with their Form 5500 by the fifteenth day of the second month following the close of the plan year (if calendar year, February 15). Where a contribution is subsequently made for the plan year, an amended Schedule B would be required to be filed under the Form 5500's existing requirements.[2] Under the Administration's proposal, these plans would be required to use a beginning of plan year valuation.[3]

ASPPA recognizes that while some accelerated information would be helpful to provide an early warning system to protect the PBGC, an expanded exemption from the new Schedule B filing requirement should be made for small to medium-sized plans, similar to the Administration's exemption for plans subject to the at-risk liability calculation based on a plan sponsor's financial health. An earlier reporting requirement for many small to medium-sized plans that do not pose a potential risk to the PBGC would unnecessarily increase administrative complexity and costs. In addition, requiring an earlier valuation date for certain small to medium-sized plans *not* subject to Administration's accelerated filing date would further expand an unnecessary administrative burden on these plans.

ASPPA recommends that only plans with 500 or more participants that are required to make quarterly contributions be required to file a report on the funded status of the plan within 90 (ninety) days after the close of the plan year (if calendar year, March 31). This reporting

[2] Under current law, defined benefit plans subject to minimum funding standards are required to file a Schedule B with the Form 5500, which is generally due seven months after the end of the plan year (if calendar year, July 31), with a two and a half month extension available (if calendar year, October 15).
[3] Under current law, defined benefit plans are allowed to use any valuation date of a plan year for disclosure purposes.

would be done using a newly-created form Schedule B-1 (which would be filed electronically, if possible) and would provide only the asset and liability information necessary to disclose the plan's funded status as of the valuation date in the prior plan year (retaining the current law structure of allowing any plan valuation date in a plan year.) Any additional reporting information, such as the annual contribution information, should continue to be reported on the regular Schedule B filed with the Form 5500. In addition, we recommend that plans *not* subject to the Administration's accelerated filing date with less than 500 participants be allowed to retain the current law structure of allowing any valuation date.

Consistent with the interests of the Administration, this new Schedule B-1 would allow the dissemination of more accurate and timely information regarding the funded status of a plan, without causing a substantial administrative or financial hardship on small to medium-sized plans that pose little potential risk to the PBGC.

The Impact of Fluctuating Interest Rates on Lump Sum Calculation

As sponsors of defined benefit plans promise a guaranteed benefit to their participants, a plan sponsor must calculate on a year-by-year basis the extent to which contributions are required to fund those promised benefits. Under current law, when a benefit will be paid in the form of a lump sum—a common occurrence for defined benefit plans—the calculation of the annual contribution requirements consists of several elements. First is the requirement that a promised benefit not exceed a specified amount (the "415 limit")[4], which is expressed in terms of a life annuity. Second, if a participant in a defined benefit plan elects benefit payment in a form other than a life annuity (*e.g.,* lump sum, term certain), the 415 limit must be converted to reflect this alternative form of benefit.

Prior to 1995, the interest rate assumption generally used when making this conversion was 5 percent. Thus, for example, the 415 limit for a lump sum distribution could be determined mathematically in advance of the participant's retirement. This permitted an employer to know exactly, upon performance of a relatively simple calculation, what its annual plan contribution obligations would be. This was particularly crucial for smaller defined benefit plans, since the payout to even one single participant can have a dramatic impact on overall plan funding, and thus on annual contribution obligations.

From 1995 to 2003, the 415 limit for forms of benefit other than a life annuity was determined by using the 30-year Treasury bond rate, which produced a fluctuating month-to-month interest rate. The Pension Funding Equity Act of 2004 (PFEA '04) amended IRC 415 to provide that for plan years beginning in 2004 or 2005, an interest rate assumption of 5.5 percent was to be used in lieu of the applicable interest rate. This temporary interest rate assumption was a welcome relief to smaller defined benefit plans, as it provided much needed simplicity and predictability in making lump sum calculations.

The Administration's proposal, while not expressly addressing the 415 issue, does not appear to extend this 5.5 percent interest rate assumption in determining the 415 limit for lump sum

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[4] The annual benefit limit under IRC 415 (the "415 limit") is the lesser of (1) 100 percent of the participant's average compensation over the highest three consecutive years, or (2) $160,000 (indexed for inflation), expressed in terms of a life annuity beginning at age 65.

calculations. Instead, the proposal seems to contemplate that the contribution amount to fund a lump sum payment subject to the 415 limit be calculated by using interest rates drawn from a zero-coupon corporate yield curve.

The complexity of the yield curve calculation would create a significant volatility problem facing small and medium-sized defined benefit plan sponsors. Using the yield curve to determine funding obligations for the 415 limit based on monthly fluctuating interest rates would make it very difficult for smaller businesses to properly fund their plans and virtually impossible to project funding obligations into future years. It would create confusion to plan sponsors and plan participants whose lump sum payment amounts may bounce up and down as these rates change. It would also cause plans to be unable to reasonably determine their liabilities with regard to benefits payable in a lump sum and other forms of payment.

Affordability issues are also raised—a plan sponsor will justifiably wonder whether it will be able to afford to guarantee the defined benefit. There would be a chilling effect on a plan sponsor's willingness to establish a plan because of the impossibility of predictability for the plan's obligations. The problems arising from being wholly dependent on the whims of a widely-fluctuating interest rate would be a major deterrent to the establishment of defined benefit plans, especially for small businesses.

In order to provide for a more predictable funding requirement for small defined benefit plans, **ASPPA recommends** that the use of the current 5.5 percent interest rate assumption for benefit forms other than a life annuity (*i.e.,* lump sums) for purposes of the 415 limits as set forth in PFEA '04 be made permanent. This use of a flat interest rate would remove the volatility from the determination of lump sums and other form of benefits, ensure consistency for planning purposes, pave the way for the potential establishment of new defined benefit plans by small businesses, and be no more generous than current law.

Reduced PBGC Premiums for Small and New Plans

Finally, while ASPPA agrees that some reform of the PBGC premium structure is necessary to increase the PBGC revenue needed to meet expected claims and improve their underlying financial condition, an exception from the Administration's proposed fixed and risk-based premium (which would replace the current Variable Rate Premium) should be created for small and new defined benefit plans that pose no significant risk to the PBGC. These plans expose the PBGC to little, if any, liability, and accordingly should be charged minimal premiums.

The Administration's defined benefit reform proposal would increase the current fixed rate to reflect the cost of living adjustment (COLA) from 1991, and index the fixed premium thereafter. The Administration would also assess a new risk-related premium on all plans with assets less than their funding target. While the premium rate per dollar of underfunding would be identical for all plans, the Administration has, however, suggested an unorthodox system that would allow this premium rate per dollar of underfunding to be set, reviewed, and revised periodically by the PBGC Board. The Administration represents that these premium increases are necessary to mitigate future losses and retire PBGC's deficit (currently valued at $23 billion) over a reasonable time period.

This new premium structure would create a great deal of uncertainty for plan sponsors every year in budgeting for PBGC premiums. Further, with unprecedented authority being provided to the PBGC Board to set the risk-related premium, there is a potential that these premiums could unnecessarily escalate for certain plan sponsors who do not pose a significant risk to the PBGC, under the pretext of decreasing the PBGC deficit. It would not only force many plan sponsors, especially small to medium-sized companies, to exit the system, it would also restrict the creation of new plans and future PBGC premium-payers.

ASPPA recommends that an exception be provided to small and new plans from these proposed PBGC premium reforms. These two non-controversial exceptions have been introduced by Congressional lawmakers in prior legislation. Most recently, they were included in the Senate Finance Committee's reintroduced pension protection legislation, the National Employee Savings and Trust Equity Guarantee (NESTEG) Act, introduced by Committee Chairman Charles Grassley (R-IA) and ranking member Max Baucus (D-MT) on January 31, 2005. They were also included in the House pension reform bill, the Pension Security Act of 2004 (H.R. 1000), introduced in the 108th Congress by House Education and Workforce Chairman John Boehner (R-OH) and passed by the House on May 14, 2003.

ASPPA proposes for new small plans[5] (maintained by controlled group with 100 or fewer employees), that the premium for each of the first five years of existence be set at $5 per participant with no risk-related premium owed. For new plans that have over 100 participants, the PBGC premium should be phased in at a variable rate over the first five years (20 percent for first year, 40 percent for second year, and so on).

Further, for very small plans (maintained by controlled groups with 25 or less employees), ASPPA proposes to either: (1) cap their variable rate premium payments for each participant to an amount equal to $5 times the number of plan participants; or (2) allow the exclusion of substantial owner benefits in excess of the phased-in amount from their variable rate premium calculations.

Conclusion

ASPPA appreciates the opportunity to offer its perspective on these very important defined benefit reform issues. We believe any new reforms should be designed to stimulate and protect the defined benefit system. ASPPA looks forward to working with the Committee and the Administration on a comprehensive solution to defined benefit reform.

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[5] A new plan means a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as in the new plan.

TESTIMONY OF
THE ERISA INDUSTRY COMMITTEE (ERIC)

SENATE FINANCE COMMITTEE
HEARING ON

AMERICA'S PENSION SYSTEM

MARCH 1, 2005

Mr. Chairman and Members of the Committee, thank you for the opportunity to present the views of The ERISA Industry Committee (ERIC) on the Bush Administration's proposals to reform voluntary single-employer defined benefit pension plans.

> ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

Since the mid-1990s, the Senate Finance Committee has been a leader in conceiving and moving to enactment legislation that improved voluntary retirement savings. For example, provisions of the Small Business Job Protection Act of 1996 (P.L. 104-188), the Taxpayer Relief Act of 1997 (P.L. 105-34), the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), and the Pension Funding Equity Act of 2004 (P.L. 108-218) supported retirement savings both by increasing opportunities for savings and by providing more rational rules for employers who voluntarily provide retirement plans to their employees.

Making EGTRRA Reforms Permanent

The Committee's leadership in the 1990s and beyond stands in contrast to legislation enacted during the 1980s when a host of limits, restrictions, and complicated rules were imposed on retirement savings plans as well as other employee benefit plans (see attached chart).

As a result of some of the changes enacted during that decade, funding for defined benefit pension plans was substantially delayed because employers' ability to project and begin to pay for future benefits was constricted through a series of new and reduced limits. Title VI of EGTRRA included provisions that partially reversed some of these funding constrictions, but the improvements will expire in 2010 unless extended by Congress. An extension of these modest improvements in pension funding was included in the President's budget. We urge that when this Committee and the Senate consider tax provisions expiring in 2010, the provisions improving pension funding be made permanent.

The Impact of Reform

The Administration has put forward a proposal to re-invent the rules governing voluntary defined benefit pensions. This sweeping proposal has some elements with which we agree but also contains many elements that will reduce retirement security by making it far more difficult for employers voluntarily to sponsor defined benefit pension plans.

The future of voluntary employer-sponsored defined benefit plans now is in Congress's, and this Committee's, hands. Whether at the end of the day employers are provided with a voluntary system that encourages them to establish, maintain, and fund pension plans – or whether they are faced with a system that discourages and even penalizes such actions will depend on the ability of Congress and stakeholders to find the right balance of rules and opportunities, risks and protections.

No system can be totally risk free and full proof. Any workable, sustainable system needs to balance legitimate concerns for security with equally legitimate concerns for business and economic competitiveness and flexibility.

This is an important conversation, and ERIC welcomes the opportunity to work with the Committee and the Administration to build a more robust voluntary defined benefit pension system.

A Sound PBGC

ERIC supports a soundly financed Pension Benefit Guaranty Corporation. As the PBGC has stated, the agency faces long term issues but does not face a liquidity crisis. It has on hand sufficient assets to pay trusteed benefits for many years into the future. Moreover, when it trustees a plan, its asset base grows. Potential issues regarding the PBGC are long term issues.

In that regard, we note that of the $23 billion deficit published by the agency at the end of 2004, $17 billion (or nearly three-quarters) was due to claims that had not yet been received by the agency – called "probable" claims. Probable claims are those the agency expects to receive in the near future, although not necessarily in 2005. Thus, airline plans recently trusteed by the PBGC most likely are already included in this deficit calculation and do not increase any reported deficit. (See chart)

The Administration Proposal

The Administration proposes to replace the current-law long-term and short-term funding rules with funding rules based on spot measures of funded status as well as on the assumed financial health of the sponsoring employer; to modify disclosures made to the general public and to participants; to substantially increase premiums paid to the Pension Benefit Guaranty Corporation as well as the number of employers who pay a variable premium; and to restrict benefits available to participants in certain circumstances.

Permanent Interest Rate

ERIC strongly supports the Administration's proposal to provide a permanent interest rate that is based on corporate bonds, even though it disagrees with the specific construction of that rate chosen by the Administration (i.e., a yield curve). Uncertainty over the applicable interest rate has caused many plans

to be frozen over the past few years and impeded sound business planning. Providing stability in this key assumption is critical. Long-term corporate bond rates enacted by Congress for 2004 and 2005 provide a realistic picture of plan liabilities and reflect a very conservative estimate of the rate of return earned by pension trusts. The 2004-2005 solution should be enacted on a permanent basis.

Deductible Contributions
ERIC also strongly supports the proposals such as those put forward by the Administration that will increase limits on deductible contributions so that employers can fund up in good times and build cushions that will help them weather downturns. There are several proposals put forward by the Administration, Members of Congress, and stakeholders that deserve consideration. The specific provisions that will be most effective, of course, will depend on the final structure of the underlying funding rules chosen by Congress.

Disclosure
As stated in its principles, ERIC also agrees that more meaningful and current disclosure can be provided to participants, although we believe substantial modifications to the Administration's suggestions are needed.

Key Concerns

Volatility and Lack of Predictability
The current law long-term funding rules, which are based on long-term assumptions, allow companies to know well in advance what their funding requirements will be, and those requirements remain relatively stable over time. The current law deficit reduction contribution (short-term) rules, which are based on a rate averaged over four years, also allow companies to know at least a few years in advance when they may become subject to faster funding requirements.

Because it is based on spot measures of a plan's funded status, the funding construction proposed by the Administration eliminates a company's ability to predict its future contribution requirements. Under the Administration's proposal, a large plan's funded status also can swing back and forth between over funded and underfunded from year to year based solely on external macro-economic factors such as interest rates and short term market performance. The down swings can place cash calls on a company in the billions of dollars.

Pension plans are provided on a voluntary basis, and few companies will be able to tolerate that much risk exposure, especially in something that is not integral to their business product. To abate (but not eliminate) this risk, a company would have to radically overfund its plan and/or modify its investment allocations – and both of these make the plan far more expensive. At a minimum, benefits earned by participants will be reduced to keep overall costs level; in many instances, employers will be pushed out of the system.

We believe instead that the current-law long term rules should be made more effective and that the DRC rules should be made both more effective and less volatile.

Procyclical Impact
The current law DRC rules are designed to delay faster contribution requirements triggered by a normal recession until the economy has begun to recover. By contrast, the Administration's spot-rate scheme would exacerbate any downturn by imposing sharp cash calls well before recovery is under way.

The proposal ignores the fact that some plans will become somewhat underfunded during an economic downturn – and that this is normal and poses no risk to the PBGC. By designing rules that essentially require plans to be 100% funded at all times, the Administration has set a bar that is neither rational nor needed in the real world.

In addition, the Administration imposes an expansive definition of liability on any company that drops below investment grade. At a minimum, this part of the proposal is a strong incentive for employers not to sponsor defined benefit plans in the future. Besides the fact that many questions have been raised about how the rating companies operate, the proposed rules may in fact trigger the problems they are trying to resolve. They may trigger a plan termination – and, in the worst circumstances, cause the demise of the company itself. Structuring pension liabilities according to a company's credit rating will cause some companies to be downgraded, increasing their cost of doing business. For a company that is climbing to investment grade, the climb is likely to be much more difficult.

Many, many companies have been or will be below investment grade from time to time and will never terminate a plan that is trusteed by the PBGC. The proposal to base liability calculations on a sponsor's credit rating is like an ineffective and harmful medical test that has too many "false positives."

Complexity and Lack of Accountability
The Administration proposes to require use of a corporate bond yield curve that would be constructed monthly by Treasury staff. This is an extraordinary transfer of authority from Congress to agency staff.

Moreover, available markets in the sections of the yield curve that are most critical to most pension plans are thin – thus the staff must interpolate interest rates at those points. This will be very difficult for Congress to monitor, but it can have enormous impact on pension plan funding requirements.

Even though the Treasury will produce a single-page spread sheet of its yield curve, application of the curve is, in fact, complex. Estimates must be made decades into the future regarding the ages at which individuals will retire and the type of benefit distribution they will choose. Application of a yield curve to lump sum distributions also is complex and will be confusing to participants. The current law interest rate also is used in numerous other provisions of pension law – and a yield curve may not be suitable for all of these.

Use of a yield curve will unnecessarily increase the volatility of pension funding since both the interest rates in the curve and the curve itself will fluctuate.

In addition, while the Administration proposes interest rates theoretically tailored to each plan's expected payout, it would still require all plans to use the same mortality tables, creating for some plans a substantial imbalance.

Disincentives to Pre-fund
An employer who makes extra contributions will be in a worse economic position than an employer who does not if contributions above minimum requirements cannot count as pre-funding of future contributions. The Administration's proposal to eliminate credit balances should not be enacted. Available credit balances should, however, be adjusted if the underlying value of the assets decreases. This preserves a key incentive for employers to pre-fund their pension obligations during good times while eliminating a flaw in the current law that could allow a plan to use a credit balance even though poor investment results had erased its value.

Excessive Premium Taxes
The proposal has been scored as requiring plan sponsors to pay a startling $26 billion in additional premium taxes over the next ten years. Moreover, the proposal would index the flat-rate premium tax to wage growth (regardless of whether the agency needed the funds) and would allow the PBGC itself to set variable rate premium tax levels.

A premium tax increase of this size is not warranted. Moreover, both the indexing and the transfer of authority to the PBGC are inappropriate. Section 4002 of ERISA, states that the PBGC is to "maintain premiums...at the lowest level consistent with carrying out its obligations..." Automatic indexing, which would occur whether or not the PBGC needed the money, is inconsistent with this directive. It is wholly inappropriate for the PBGC to set the variable premium tax levels. Premium tax levels must balance the financial needs of the agency with the social goals of supporting a voluntary private pension system. Only Congress has the breadth of view and the recognized authority to make these judgments.

Principles Regarding Pension Funding and Financial Disclosure to Participants

At a time when members of the Baby Boom cohort are entering their retirement years, the government should assist employers who voluntarily sponsor retirement plans for their employees. Meeting the nation's retirement income needs is an important public policy objective that cannot be met by reliance on government, employers, or individuals alone. Employers offer several different forms of retirement savings vehicles, among them traditional and hybrid defined benefit pension plans in which employees accrue benefits without incurring the risk of investment loss. These plans remain vital to the ability of individuals to achieve financial security in retirement.

ERIC believes the Committee's actions should be based on the following principles governing pension funding and financial disclosure to participants:

Regulatory Environment: The federal government must create a regulatory environment that encourages the establishment, continuation, and long-term viability of defined benefit pension plans by providing plan sponsors with the certainty they need regarding –

* the interest rate used to calculate their liabilities;
* rules that support predictable and stable plan funding
* the validity of cash balance and other hybrid plan designs;

In addition, rules governing pension plans must balance the interests of participants and of employers who voluntarily sponsor defined benefit plans. They must recognize the differences and need for flexibility among employers in plan design and the varying needs and interests of different workforces. Specifically:

* Legislation must be enacted as soon as possible that establishes a realistic and permanent interest rate assumption that appropriately measures the present value of pension plan liabilities and that, with an appropriate phase in, is applied to the minimum amount of any lump-sum distribution that a pension plan makes. The failure to change the current rate applicable to lump sums has resulted in lump sum distributions that are outsized relative to economic reality and the plan's funded status and has created an artificial incentive for participants to take their benefit in a lump sum.

* Pension funding standards must strike the appropriate balance that encourages employers both to establish and maintain defined benefit pension plans and to fund the plans on a reasonable and appropriate basis, thus protecting participants. This is essential to protecting the financial health of the pension system and the business vitality of plan sponsors. For example, legislation imposing additional requirements or benefit restrictions on plans less than fully funded should not be triggered by the credit rating of the sponsoring employer. This measure creates too many "false positives." It would impose unnecessary burdens on a large number of employers who otherwise are not likely to terminate their plans, making their business recovery more difficult and in some cases triggering the very plan termination that the funding rules should seek to avoid.

* Employers must not be discouraged from developing new plan designs that meet the changing needs of the current and future workforce. Legislation must be enacted that confirms the legality and facilitates the adoption and continuation of hybrid plans so that employers will be more likely to continue to offer pension plans.

* The Pension Benefit Guaranty Corporation (PBGC) must align its objectives with those of employers and participants since a flourishing private pension system is the best guarantee of the PBGC's long-term viability. In other words, as required under ERISA, PBGC must set policies and act to encourage the establishment and continuation of voluntary defined benefit plans. Plan funding and premium policies should not force employers out of the voluntary pension system prematurely and unnecessarily during periods of financial distress or normal economic downturns.

Funding Objectives: In order to ensure that employees will receive pension benefits from employer-sponsored plans, the primary objectives of funding standards must be to foster plan continuation through actuarially sound funding and to allow plan sponsors to anticipate systematic and stable funding over time.

* Required contributions must be both predictable and stable in order to facilitate capital

planning in the sponsoring business.

* Funding standards should permit the pre-payment of contributions when sponsors are able to do so.

* Funding standards must allow and facilitate diversification of investments of pension plan assets, including investments in equities, in order to ensure the growth and security of the plan.

* Funding standards must recognize the on-going and long-term nature of pension plans; the primary focus of funding requirements should be based on long-term measures and long-term assumptions.

* Short-term measures of a plan's funded status should be monitored and taken into account in funding and disclosure decisions, but also must balance funding goals with the need to avoid forcing plan sponsors to choose between funding their plans and maintaining the viability of their businesses.

Financial Disclosure to Participants: More meaningful and more current disclosure is needed. Summary annual reports are not meaningful. Investors receive better and more current information than do plan participants.

* Plans should be required to provide participants early each year with a statement of the plan's funded status based on timely information currently available -- such as information on plans compiled for SFAS 87 disclosures.

* The new report should replace the summary annual report.

* As under current law, plans may provide participants with additional information.

Underfunded Plans: To prevent the occurrence of benefit accruals that are not likely to be funded within a reasonable period of time and to reduce the PBGC's exposure to such benefit accruals, special restrictions on benefit increases and payouts should be imposed on plans that are severely underfunded and likely to terminate. This will limit cost shifting from failed plans to ongoing plans through increased PBGC premiums.

* Restrictions should be imposed on a graded scale – the most severe restrictions reserved for the most underfunded plans.

* Restrictions imposed on benefit accruals or lump sum distributions must be workable and as minimally disruptive of business operations, workforce management goals, and participants' needs as possible, and not invite or lead to lawsuits against employers.

Conclusion

To secure defined benefit pension plans and lay the groundwork for their expansion in the future, Congress must take action now to:

* adopt the long-term corporate bond rate as a permanent interest rate for calculating liabilities, and

* provide legal certainty for hybrid plans.

However, before enacting pension funding reforms, Congress must ensure that reforms result in rules that support predictable and stable plan funding.

The Administration has stated that it wants to ensure that plans are funded so employees will be assured of receiving their benefits. We agree. But aspects of the specific proposal put forward are so harsh, volatile and unpredictable that many plan sponsors will be forced to freeze their plans, and in some cases may be forced into bankruptcy. Moreover additional workers will not have the opportunity to earn pension benefits because their employer will not consider installing a defined benefit plan under such a structure.

The Administration also has stated it wants to avoid a taxpayer bailout of the PBGC. We agree. But the best assurance of a sound PBGC is a robust defined benefit system. We do not believe that the Administration's proposal accomplishes this goal and in fact may put the PBGC in a worsening position.

We appreciate the opportunity to present our views and look forward to working with the Committee and the Administration to provide opportunities for American workers to attain lasting retirement security.

BUDGET REDUCTIONS* AFFECTING EMPLOYEE BENEFITS

LAWS ENACTED 1982 - 1994

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 **(TEFRA) P.L. 97-248**
Lower limits to compute pension contributions and benefits (I.R.C.§415) from $136,425 and $45,475 to $90,000 and $30,000, frozen until 1986; reduce combined plan limit. Limit plan loans. Require plan distributions at age 70-1/2 or retirement. Reduce integration in defined contribution plans. Impose stricter leased employee rules. Impose new nondiscrimination rules on group term life insurance (I.R.C.§79).

Est. five year net revenue gain of $3.872 billion (1983-1987)
[Est. three year gain: $1.844 billion]

DEFICIT REDUCTION ACT OF 1984 (DEFRA) P.L. 98-369
Freeze §415 limits until 1988. Repeal PAYSOPs. Limit deductions for contributions to I.R.C.§501(c)(9) trusts (VEBAs). Impose limits on group term life insurance for retirees. Repeal estate tax exclusion for qualified plan benefits. Expand leased employee restrictions. Expand nondiscrimination standards for 401(k) plans. Restrict tax exclusion of fringe benefits and benefits available under cafeteria plans (I.R.C.§125 plans). Limit vacation pay; and make other changes.

Est. five year net revenue gain of $4.094 billion (1985-1989)
[Est. three year gain: $2.472 billion]

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985 (COBRA) P.L. 99-272
Require continuation health coverage ("COBRA coverage"). Increase PBGC premiums; restrict plan terminations.

Est. three year net revenue gain: $0.666 billion (1986-1988)

TAX REFORM ACT OF 1986 (TRA-86) P.L. 99-514
Limit deductions for business meals, travel, and entertainment. Restrict availability of IRAs. Impose cap on elective contributions to and impose new nondiscrimination rules on 401(k) plans. Impose tax on pre-retirement distributions. Repeal 10-year averaging. Repeal three year basis recovery. Reduce early retirement §415 limits. Reduce deduction limits for plan contributions. Impose 10% excise tax on reversions. Cap dependent care assistance. Impose nondiscrimination rules on welfare benefit plans. Limit ESOPs; and make other changes.

Est. five year net revenue gain of $50.299 billion (1987-1991)
[Est three year gain: $28.794 billion]

OMNIBUS BUDGET RECONCILIATION ACT OF 1987 (OMBRA) P.L. 100-203
Reform pension funding. Impose 150% of current liability cap on pension funding. Increase PBGC premiums; and make other changes.

Est. three year net revenue gain 1988-1990: $3.580 billion

TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988 P.L. 100-647
Increase excise tax on reversions. Make numerous technical corrections. Change COBRA penalties. Modify Section 89; and make other changes.

Est. three year net revenue loss 1989-1991: $0.279 billion

OMNIBUS BUDGET RECONCILIATION ACT OF 1989 P.L. 101-239

Restrict ESOPs. Restrict prefunding of retiree health. Impose new mandatory penalty on violations of ERISA. Extend educational assistance and legal services. Expand COBRA; and make other changes.

Est. five year net revenue gain: $9.390 billion (1990-1994)

OMNIBUS BUDGET RECONCILIATION ACT OF 1990 P.L. 101-508
Allow transfers of excess pension assets to pay for retiree health benefits. Increase excise tax on pension plan reversions. Increase PBGC premiums. Extend user fees. Extend educational assistance and legal services; and make other changes.

Est. five year net revenue gain: $354 million (1991-1995)

BUDGET RECONCILIATION ACT OF 1993 P.L. 103-66
Repeal the Medicare hospital insurance (HI) taxable wage base cap. Reduce the amount of compensation that can be taken into account in computing pension contributions and benefits from $235,840 to $150,000. Extend educational assistance. Facilitate real estate investments by pension funds.

Est. five year net revenue gain: $30.398 billion (1994-98)
[Repeal of HI cap = $29.1 billion five-year revenue gain]

GATT IMPLEMENTATION ACT, 1994 P.L.103-465
Reform pension funding and provisions of law affecting the PBGC (including removing cap on variable rate premium). Extend retiree health transfers under IRC §420. Slow down indexing of plan limits.

Est. five year net revenue gain: $1.757 billion (1995-99)

IN ADDITION: For the past several years, each budget reduction has included billions of dollars in "savings" in federal payments under Medicare and Medicaid. This has resulted in increased charges to other payers (including employee benefit plans). The Prospective Payment Commission has estimated that costs to other payers have increased an average of 28%.

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* NOTE: The revenue estimates included in this memorandum are the estimates provided at the time of the bill's passage by Congress. They do not reflect subsequent changes in underlying tax rates or in other provisions of law. Several bills include benefit provisions that increase federal expenditures as well as provisions that reduce federal expenditures. The estimates included in this memorandum are net amounts.

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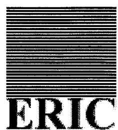
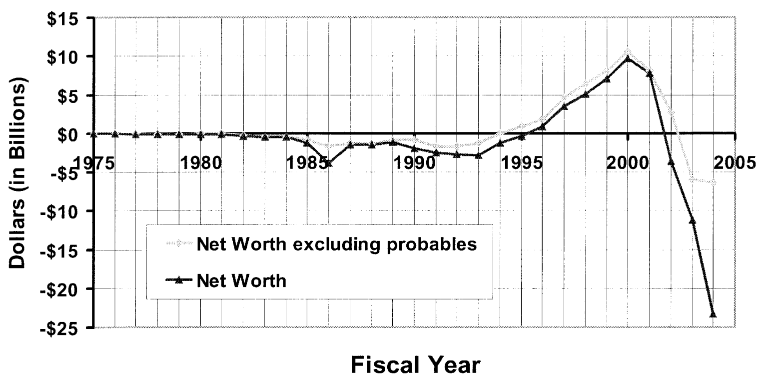
Probables Drive New Numbers





Source: Ron Gebhardtsbauer, American Academy of Actuaries from PBGC filings

Statement for the Record
March of Dimes
1146 19th Street, N.W.
6th Floor
Washington, DC 20036

For a Hearing of The Senate Finance Committee on the Financial Status of PBGC and the Administration's Defined Benefit Plan Funding Proposal

Washington, DC
March 1, 2005

The March of Dimes is pleased that the Senate Finance Committee has called a hearing to examine the issues facing defined benefit plans and the financial health of the Pension Benefit Guaranty Corporation (PBGC). These are areas where improvements can be made. At the same time, it is also essential that any reforms avoid unduly and unnecessarily adding to the burdens of employers that voluntarily sponsor defined benefit plans.

The March of Dimes is a national voluntary health agency whose mission is to improve the health of babies by preventing birth defects and infant mortality. Founded in 1938, the March of Dimes funds programs of research, community services, education, and advocacy to save babies. Since 1948, we have maintained a defined benefit plan for the benefit of our employees.

As the Finance Committee begins the work of strengthening the defined benefit system, we ask that you carefully consider the impact any pension reform legislation would have on charities and other nonprofit organizations (collectively, "NPOs") that sponsor defined benefit plans.

NPOs face unique challenges as employers that sponsor defined benefit plans. Changes in the state of the national economy or sudden catastrophic events tend to have a greater impact on NPOs' cash flows, on the whole, than other employers. To weather the ups and downs of charitable giving while carrying out our charitable purpose, the March of Dimes must be able to predict, and thus prepare to meet, our basic financial obligations. Among those is our obligation to fund the defined benefit plan that we sponsor for our employees. In our view, the single most important step Congress could take to ensure the continued viability of the defined benefit system is enact a permanent replacement for the obsolete 30-year Treasury bond interest rate used for pension calculations. A permanent interest rate that accurately reflects employers' pension funding obligations is critical to the functioning of the defined benefit system. We commend Congress for enacting a temporary corporate bond replacement rate; however, the temporary rate is scheduled to expire at year-end and the current uncertainty regarding future pension liabilities hampers the ability of defined benefit plan sponsors, like us, to make long-term business plans. An appropriate and permanent interest rate is needed as soon as possible.

We also have concerns regarding some of the Administration's pension funding reform proposals and their potential effect on the ability of NPOs to plan for future pension costs. The Administration has proposed that pension funding liability be calculated using an interest rate based on a spot yield curve. It has also proposed eliminating the smoothing of asset values. As mentioned above, predictability is of the utmost importance for financial planning in today's charitable giving climate and enables us to budget plan contributions in advance. The Administration's proposals could lead to dangerous volatility in funding and premium obligations, without a concomitant increase in accuracy. For that reason, we urge you to maintain the current law practice of smoothing, which promotes long term pension funding stability.

Another unique NPO issue raised by the Administration's proposals is the linking of pension funding obligations to creditworthiness. Under the Administration's proposals, a plan's funding target, contribution requirements and premium obligations would all be tied to its credit rating. However, to date we have not seen any guidance regarding the application of these rules to NPOs or other organizations that do not have public debt subject to a rating.

The Administration's reform proposals would completely overhaul existing pension funding rules for single-employer defined benefit plans. The proposed changes, if enacted, would be the most significant since ERISA was enacted in 1974. It will take time for employers that sponsor defined benefit plans and plan service providers to fully analyze all the implications and interactions of the myriad proposed changes. We hope that before the Committee recommends any pension funding reforms, it will carefully examine each proposal with a particular focus on the potential impact on NPOs such as the March of Dimes. Furthermore, we hope that the effective date for implementation of the proposals will allow adequate time for review and analysis.

March 2, 2005

The Honorable Charles Grassley
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

HR Professionals Support PBGC Solvency & Shoring-up DB Plans

Chairman Grassley and Ranking Member Baucus:

The Society for Human Resource Management (SHRM) applauds your collective efforts over the past several years to craft legislation that will ensure the integrity of the defined benefit (DB) pension system and the solvency of the Pension Benefit Guarantee Corporation (PBGC). SHRM and its members remain committed to a flexible pension system that meets the retirement needs of its workforce and the financial goals of its organizations. Specifically, SHRM wants to make sure that pension promises are kept and pension plan requirements are equitable yet effective.

The Society for Human Resource Management (SHRM) is the world's largest association devoted to human resource management. Representing more than 190,000 individual members, the Society's mission is to serve the needs of HR professionals by providing the most essential and comprehensive resources available. As an influential voice, the Society's mission is also to advance the human resource profession to ensure that HR is recognized as an essential partner in developing and executing organizational strategy. Founded in 1948, SHRM currently has more than 500 affiliated chapters and members in more than 100 countries.

As public and private employee benefit plan sponsors, managers and administrators, HR professionals are intimately involved in all aspects of pension plan management and administration. We appreciate this opportunity to share with you our thoughts on the Administration's proposal to strengthen funding for single-employer pension plans and offer the following specific comments on the Administration's proposal:

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Improve Disclosure

The Administration proposes to provide increased information about a plan's funding status and timelier plan funding information. SHRM supports increased disclosure to plan participants on plan funding and financial status but remains concerned that some information or actuarial calculations may be overly complex for both plan sponsors and plan participants. SHRM is worried that complex actuarial assessments or assumptions, without comprehensive and lengthy explanations, may lead to confusion. Such false impressions or misunderstandings about plan solvency could generate unwanted economic market fluctuations, inconsistent industry information, and undermine confidence in the plan's solvency.

Determining Liabilities

The Administration proposes to base the interest rates used for present value calculations for pension funding obligations on a yield curve valuation. SHRM supports using a more accurate valuation method as it provides a better indication of a plan's obligations. However, we are hesitant to fully support the yield curve valuation method because it potentially introduces increased volatility in assessing plan liabilities. Plan liabilities would become dependent not only on fluctuations in interest rates but also on changes in the shape of the yield curve and on changes in the duration of plan liabilities. This type of volatility in pension obligations undermines employers' ability to predict and budget their costs and has already been a significant deterrent to organization's retaining DB plans as a retirement plan option. SHRM believes there are alternate valuation models that approximate the effect of a yield curve without adding as much complexity to the calculations or actuarial volatility; which if continued would maintain the current trend of employer's preferences for other types of qualified pension plans.

Minimum Funding Credit Balances

The Administration proposes that the minimum required contribution to the plan for the year would be equal to the sum of the applicable normal cost for the year and eliminates the alternative minimum funding standards. SHRM supports employer flexibility to assist in the management and administration of pension plans and would therefore encourage policies that would permit credit balances. Furthermore, the elimination of the alternative funding standards limits funding flexibility as well as the need for a funding standard account. Although making larger than required contributions would not directly reduce a sponsor's future minimum funding requirements, SHRM believes the additional contributions could accelerate the date when the plan's assets reach its funding target (eliminating the need for amortization payments), reduce the amount of otherwise required new amortization payments, remove certain restrictions on plan benefits, and reduce PBGC premiums.

Tax Deductible Contribution Limits

The Administration proposes to permit funding on a tax deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year. SHRM supports the Administration's proposal to increase the spread between the minimum funding target and the maximum tax-deductible level. This approach provides a way for organizations to stabilize contributions from year to year. SHRM also suggests that considerations be made to allow limited access for post-retirement medical benefits under IRC Section 420. SHRM believes this option would increase an employer's flexibility in providing post-retirement benefits.

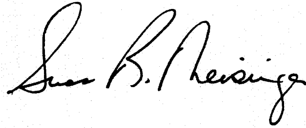
Phased Retirement
Although not addressed in the Administration's proposal, SHRM believes Congress should create a formal phased retirement structure in order to assist employers in workforce replacement challenges anticipated as a result of the impending retirement of the baby boom generation. A nontraditional work schedule with retirement flexibility — phased retirement — will be a key workplace issue in the 21st century.

Contributions During Economic Prosperity
The Administration's proposal strives to provide employers with additional flexibility while meeting the plans financial obligations. SHRM believes organizations should be permitted to make additional contributions during times of economic prosperity. Providing this option for employers sets an example for "planned responsible saving" and provides organizations with additional flexibility during times of unforeseen economic downturn.

SHRM supports Administration and Congressional efforts to encourage continued and new participation in the defined benefit system as well as measures to ensure that plans fully meet their funding obligations. SHRM especially appreciates the Administration's proposal to simplify the current funding rules by essentially establishing one set of required calculations.

SHRM believes that government shares responsibility with Americans to achieve adequate retirement income, and encourages Congress to continue supporting a voluntary employer-provided retirement system for employees. We look forward to working with you in the months ahead to develop a long-term solution that will ensure the integrity of the DB pension system and the solvency of the PBGC. Thank you.

Respectfully,



Susan R. Meisinger, SPHR
President and Chief Executive Officer
Society for Human Resource Management

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